(10)

No. 97-147-CFX   Title: Atlantic Mutual Insurance Company, Petitioner
v.
Commissioner of Internal Revenue

Docketed: July 24, 1997   Court: United States Court of Appeals for the Third Circuit

Entry	Date	Proceedings and Orders
	Jul 22 1997	Petition for writ of certiorari filed. (Response due September 24, 1997)
	Aug 18 1997	Order extending time to file response to petition until September 24, 1997.
	Sep 19 1997	Brief of respondent Commissioner of Internal Revenue filed.
	Oct 1 1997	DISTRIBUTED. October 17, 1997
	Oct 1 1997	Reply brief of petitioner Atlantic Mutual Insurance Co. filed.
	Oct 20 1997	Petition GRANTED. SET FOR ARGUMENT March 2, 1998. ***
	Dec 4 1997	Brief of petitioner Atlantic Mutual Insurance filed.
	Dec 4 1997	Joint appendix filed.
	Dec 4 1997	Brief amici curiae of American Insurance Association, et al. filed.
	Dec 4 1997	Brief amicus curiae of AmBase Corporation filed.
	Dec 22 1997	CIRCULATED.
	Jan 5 1998	Brief of respondent Commissioner of Internal Revenue filed.
	Jan 21 1998	Record filed.
	Jan 26 1998	Record filed.
	Feb 3 1998	Reply brief of petitioners Atlantic Mutual Ins. Co. and Includible Subsidiaries filed.
	Mar 2 1998	ARGUED.

1 PP

Supreme Court, U.S.
FILED

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No. 97-

In the
Supreme Court of the United States
October Term, 1997

ATLANTIC MUTUAL INSURANCE CO. and
Includible Subsidiaries,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Third Circuit

PETITION FOR WRIT OF CERTIORARI

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85 pp

QUESTION PRESENTED

Whether the United States Court of Appeals for the Third Circuit incorrectly reversed a decision of the United States Tax Court, which, consistent with a decision of the United States Court of Appeals for the Eighth Circuit, held that Treas. Reg. § 1.846-3(c)(3) is not a valid interpretation of the term "reserve strengthening" used in § 1023(e)(3) of the Tax Reform Act of 1986?

PARTIES TO THE PROCEEDING

All the parties are named in the caption.

STATEMENT PURSUANT TO RULE 29.6

There are no parent or subsidiary companies to be listed under the provisions of Rule 29.6.

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TABLE OF AUTHORITIES

OTHER AUTHORITY:

No. 97-

In the
SUPREME COURT OF THE UNITED STATES

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ATLANTIC MUTUAL INSURANCE CO. and Includible Subsidiaries,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

PETITION FOR WRIT OF CERTIORARI

Atlantic Mutual Insurance Company and Includible Subsidiaries respectfully petition for a writ of certiorari to review the judgement and opinion issued by the court below.

OPINIONS BELOW

The opinion of the Third Circuit is reported at 111 F.3d 1056 and is set forth in its entirety in the Appendix hereto at A-1. The opinion of the Tax Court, reversed by the Third Circuit, is reported as *Atlantic Mutual Insurance Co. v. Commissioner*, 71 T.C.M. (CCH) 2154 (1996) and is set forth in the Appendix at A-26.

JURISDICTION

The decision below was issued by the Third Circuit on April 24, 1997 and judgment was entered on that date. Petitioner herein, Atlantic Mutual Insurance Company and Includible Subsidiaries (hereinafter "Atlantic"), did not file a petition for rehearing in the Third Circuit. In accordance with 28 U.S.C. § 2101(c), this Petition is filed within ninety days of the date judgment was entered. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant portions of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023, 100 Stat. 2085, 2404; of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 216, 98 Stat. 494, 758; and of Treas. Reg. § 1.846-3(c) (26 C.F.R. § 1.846-3(c)) (hereinafter sometimes referred to as the "regulation") are set forth in the Appendix at A-48, A-50, and A-52, respectively.

STATEMENT OF THE CASE

Atlantic is a property and casualty ("P&C") insurer. Since 1921, P&C insurers have been allowed, for federal income tax purposes, to reduce income by the amount of their "losses incurred" each year, including any increases in reserves for unpaid losses and loss adjustment expenses arising under insurance and reinsurance policies ("loss reserves"). In § 1023 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2404 (the "Act"), Congress required that P&C insurers discount to present value loss reserves taken into account in computing losses incurred each year. Under the provisions of the Act, loss reserves were to be discounted beginning in 1987.

Congress recognized that the use of discounted loss reserves at year-end 1987 and undiscounted loss reserves at year-end 1986 to compute the deduction for losses incurred in 1987 would severely impact P&C insurers by requiring them to include in income in 1987 the entire amount of the difference between undiscounted and discounted loss reserves. Congress, therefore, provided a "fresh start" in § 1023(e)(3)(A) of the Act. Thus, year-end 1986 loss reserves were not required to be discounted in the computation of the deduction for losses incurred in 1986, while for purposes of computing the deduction for losses incurred in 1987, both the year-end 1986 and 1987 loss reserves were to be discounted. The difference between the undiscounted and discounted amounts of the year-end 1986 loss reserves, i.e., the "fresh start," was permanently excluded from taxable income. Recognizing, however, that the fresh start provision could be subject to abuse, Congress provided in § 1023(e)(3)(B) of the Act that the amount of the discount on any increase in loss reserves due to "reserve

strengthening" in 1986 would be eliminated from the fresh start. Any such elimination results in an increase in 1987 taxable income.

On September 4, 1992, the Treasury Department issued a sweeping regulatory interpretation of the phrase "reserve strengthening" in § 1023(e)(3)(B) of the Act. For loss reserves at year-end 1986 for losses that occurred in 1985 and prior years ("pre-1986 accident years"), the regulation includes a so-called "mechanical test" for reserve strengthening. If a reserve at December 31, 1986 for pre-1986 accident year losses exceeded the amount of the reserve at December 31, 1985 less the amount paid in 1986 on those losses, the excess is automatically deemed "reserve strengthening." Treas. Reg. §§ 1.846-3(c)(1) and (3). In short, the regulation sweeps into the definition of "reserve strengthening" <u>all</u> 1986 increases in loss reserves for pre-1986 accident years. The regulation applies the definition without regard to whether such increases resulted from changes in a P&C insurer's reserving methods or assumptions or from normal and routine increases in a P&C insurer's policy liabilities.[1]

The relevant facts in this case involving the validity of Treas. Reg. §§ 1.846(c)(3) are not in dispute. Atlantic is the common parent of affiliated corporations filing a consolidated return. The parties stipulated: 1) Atlantic's loss reserves were reasonable in amount at the end of 1985 and 1986; 2) in establishing its loss reserves as of December 31,

[1]In fact, the mechanical test also includes in "reserve strengthening" the excess of any 1986 loss payment over the related year-end 1985 loss reserve even though that loss reserve was eliminated as of year-end 1986 by reason of the payment and, therefore, there could not be any addition made to a reserve.

1986, Atlantic computed its loss reserves using the same methodologies and assumptions used in determining its loss reserves as of December 31, 1985; 3) measured by subsequent payments and loss reserves remaining to be paid as of December 31, 1993, Atlantic's 1986 loss reserves were more inadequate than its 1985 loss reserves; and 4) Atlantic did not increase in 1986 its loss reserves for pre-1986 accident years for tax motivated reasons.

In its tax return for 1987, Atlantic included the entire difference between its undiscounted and discounted loss reserves at December 31, 1986 in the fresh start allowed by the Act. Based on the mechanical test of § 1.846-3(c)(3) of the regulation, Respondent determined that a portion of Atlantic's year-end 1986 loss reserves for pre-1986 accident years resulted from reserve strengthening. Respondent calculated the amount of reserve strengthening by subtracting from Atlantic's year-end 1986 loss reserves for pre-1986 accident years the net of its loss reserves at year-end 1985 less payments made in respect of such loss reserves during 1986. Based on this determination, Respondent issued a statutory notice of deficiency to Atlantic.

Atlantic petitioned the United States Tax Court for redetermination of the deficiency pursuant to §§ 6213(a) and 7442 of the Internal Revenue Code. The matter was submitted to the court for decision on the basis of facts which were fully stipulated except for the testimony contained in the reports of four expert witnesses regarding the meaning of the term "reserve strengthening" in P&C insurance. The Tax Court relied on its prior decision (reviewed by the entire court) in *Western National Mutual Insurance Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd*, 65 F.3d 90 (8th Cir. 1995), which held that the term "reserve

strengthening" is not ambiguous and that the regulation at issue is invalid to the extent that it defines all additions to reserves as reserve strengthening. As a consequence, the Tax Court determined that Atlantic was not liable for the proposed deficiency because Atlantic had made no reserve increases constituting "reserve strengthening" within the meaning of the Act.

Respondent appealed the Tax Court's decision to the Court of Appeals for the Third Circuit. In a decision entered April 24, 1997, the Third Circuit reversed the decision of the Tax Court, and in so doing, it expressly refused to follow the decision of the Eighth Circuit in *Western National*. Directly contrary to the decision of the Eighth Circuit, the Third Circuit found the term "reserve strengthening" in the statute to be ambiguous and the regulation to be a permissible construction of the statute.

REASONS FOR GRANTING THE PETITION

The decision of the Third Circuit directly conflicts with the Eighth Circuit's decision in *Western National Mutual Insurance Co. v. Commissioner*, 65 F.3d 90 (8th Cir. 1995), *aff'g*, 102 T.C. 338 (1994), a case involving facts which the Tax Court here found to be indistinguishable. Because the issue involved affects a broad segment of the insurance industry, a decision of this Court is necessary to assure uniformity of treatment consistent with the proper application of federal tax laws. Further, the reasoning of the Third Circuit conflicts with standards of statutory interpretation established by this Court which should have resulted in a determination that the regulation is invalid to the extent it defines all additions to reserves as reserve strengthening.

I.

The Decision Below Is in Direct Conflict with a Decision of the Court of Appeals for the Eighth Circuit and That Conflict Will Have Serious Repercussions for P&C Insurers.

The decision of the Third Circuit directly conflicts with the decision of the Eighth Circuit. In reversing the Tax Court's holding, the Third Circuit referred to the holding of the Court of Appeals for the Eighth Circuit that § 1.846-3(c) is invalid in relevant part. The court then stated that "[w]e respectfully disagree." *Atlantic Mutual Insurance Co. v. Commissioner*, 111 F.3d 1056, 1061, n. 7 (3d Cir. 1997).

The conflicting decision of the Eighth Circuit in *Western National* is recent and thoroughly reasoned. It affirms a decision of the Tax Court that was reviewed by the entire court. The Third Circuit did not rely upon any statutory or judicial developments subsequent to the issuance of the Tax Court and Eighth Circuit decisions which could change the decisions reached by those courts in *Western National*. A conflict is thus certain to persist even after other federal courts have an opportunity to consider the issue.

As a result, uniformity of treatment of different taxpayers with respect to this industry issue cannot be attained without resolution by this Court. Respondent stated in her brief to the Third Circuit in this case that the identical issue is pending in approximately 50 other cases with total adjustments of $1,000,000,000. There will be disparate treatment for litigants in different jurisdictions unless and until this Court ultimately rules on the issue.

In short, this case presents an ideal opportunity for resolution of a conflict that will continue and cannot be resolved short of a decision by this Court. The Tax Court specifically held that this case is "factually indistinguishable" from *Western National*. Although there was some differing expert testimony in each case regarding the definition of the term "reserve strengthening" in the insurance industry, the Eighth Circuit indicated that it would have reached the same conclusion without regard to expert testimony. The Tax Court and Eighth Circuit, on the one hand, and the Third Circuit, on the other, have fleshed out the arguments to be made with respect to the issue. There is nothing that would prevent this Court from resolving the conflict regarding the validity of the disputed regulation.

II.

The Third Circuit's Decision Conflicts with Standards of Statutory Interpretation Established by This Court.

There is a strong presumption that Congressional intent is expressed through the statutory language it chooses. The Third Circuit's decision conflicts with this presumption. Congress used the same term, "reserve strengthening," in § 1023(e)(3)(B) of the Act that it used in § 216 of the Deficit Reduction Act of 1984 ("DEFRA"), Pub. L. 98-369, 98 Stat. 494. The meaning of the term when used in DEFRA has never been in dispute. No statutory language was used to differentiate the meaning of the same term two years later in § 1023(e)(3)(B) of the Act. Nevertheless, the Third Circuit held that § 1023(e)(3)(B) is ambiguous. After so holding, the Third Circuit turned to ambiguous legislative history to give deference to a definition in a Treasury regulation of the

term "reserve strengthening" that is inconsistent with the undisputed meaning of the term as used in a predecessor statute.

As noted above, for 1987 and later years the Act significantly changed the way P&C insurers compute reserves for federal income tax purposes by requiring discounting. The Act contained a fresh start provision and an exception from the fresh start provision for "reserve strengthening." With respect to the reserve strengthening exception, § 1023(e)(3)(B) of the Act provides as follows:

> Reserve strengthening in years after 1985. -- [The fresh start] shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

While the statute does not expressly define the term "reserve strengthening," there is a plain meaning to be given to that term following the principles of statutory interpretation established by this Court.

Just two years prior to the Act, Congress significantly changed the way in which life insurance companies calculate reserves for federal income tax purposes. DEFRA §§ 201-231. Like the Act, those provisions contained a "fresh start" provision and a "reserve strengthening" exception. DEFRA § 216. In relevant part, DEFRA § 216(b)(3) contains the following reserve strengthening provisions:

> (3) Reinsurance transactions, and reserve strengthening, after September 27, 1983. --

> (A) In general. -- Paragraph (1) [general rule for fresh start adjustment] shall not apply . . .
>
> * * * * *
>
> (ii) to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984.

In this connection, Respondent and the Third Circuit agree that Congress used the term "reserve strengthening" in DEFRA in accordance with life insurance usage -- that is, reserve additions resulting from a change in a method or assumption used in calculating policy reserves.

The term "reserve strengthening" has a comparable meaning in P&C insurance. As the Tax Court stated in *Western National*:

> Generally, increases in a company's reserves are either attributable to (1) normal additions made each year to fund existing and increasing obligations under policies in force; or (2) additions required when a method or assumption used in calculating policy reserves is changed so as to produce higher reserves. The latter or less usual occurrence has been described as reserve strengthening. 102 T.C. at 351.

Indeed, no matter what other conclusions may be drawn from the expert testimony in this case, it is clear that all of

the experts acknowledged that the term "reserve strengthening" has been used in P&C insurance to mean reserve increases resulting from a change in the taxpayer's methodology or assumptions used for calculating loss reserves.

When Congressional intent is clear from reading the statute, "that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of congress." *Chevron U.S.A., Inc., v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). There is a strong presumption that Congressional intent is expressed through the statutory language it chooses. *See West Virginia University Hospitals, Inc. v. Casey*, 499 U.S. 83, 83 (1991); *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 240-241 (1988); *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982). This Court has held that when the meaning of a phrase is plain, there is no need for recourse to legislative history. *West Virginia University Hospitals, supra.*

Moreover, Congress is presumed to intend an established meaning of a term when it uses the term, absent an affirmative statement by Congress that clearly and unequivocally indicates that the common meaning is not intended. *See, e.g., Rowan Companies, Inc. v. United States*, 452 U.S. 247 (1981); *United States v. Olympic Radio and Television*, 349 U.S. 232 (1955). In *Rowan*, this Court considered the validity of longstanding regulations relating to the withholding of FICA and FUTA taxes on "wages." The same term, "wages," was also used in the provisions of the Code relating to the withholding of income taxes. The regulations under the income tax provision excluded from "wages" the value of "room, board, etc." provided to an

employee for the convenience of the employer. A similar exclusion was not included in the regulations relating to FICA and FUTA taxes. "Wages" for such taxes were defined by the regulations to include the value of "room, board, etc." even though excluded from "wages" for withholding of income tax.

The taxpayer in *Rowan* argued that "wages" for withholding of FICA and FUTA taxes should have the same meaning as "wages" for income tax withholding. The Commissioner argued that because FICA and FUTA taxes compose a distinct system of taxation, the rules applicable to income taxation did not apply. The Commissioner supported the regulations with selected language from the legislative history to the FICA and FUTA provisions to the effect that "wage[s]... include compensation for services in any other form such as room, board, etc."

This Court rejected the arguments of the Commissioner in *Rowan*, and held the regulations relating to withholding of FICA and FUTA taxes invalid because the term "wages" in the circumstances should not be interpreted as having two meanings. The result followed from a strong presumption in favor of a consistent interpretation of an identical statutory term. This Court was not persuaded by selected language from the legislative history that "could be reconciled with" the regulations in issue.

In this case, the Third Circuit failed to adhere to the *Rowan* principal, and as a consequence, misapplied the principles set forth in *Chevron*. In *Chevron*, this Court held that a court should first examine whether Congress has directly spoken to the question at issue. In applying this first prong of *Chevron*, the Third Circuit failed to recognize that

in the circumstances the *Rowan* principle eliminated the necessity of going beyond the plain meaning of the statute. Thus, when Congress uses a term that was used previously in another statute, Congress is presumed to intend the same meaning as in the previous statute unless there is an unambiguous showing to the contrary.

Here, Congress used a term, "reserve strengthening," that had been used just two years before in a statute relating to a transition from one set of provisions for insurance reserve computation to another. DEFRA § 216. The meaning of the term so used was defined by consistent usage in the insurance industry for more than thirty years. *See, e.g.*, *Western National*, 65 F.3d at 92-93, and authorities cited therein. That meaning was and is not in dispute, and is also consistent with usage in P&C insurance. As the Tax Court concluded in *Western National*:

> [I]n enacting TRA 86 section 1023, Congress could not have expected a different quantitative or qualitative meaning for the term "reserve strengthening," depending upon whether it was used in connection with tax provisions specifically designed for life or P&C companies. The fact that the same terminology was used as was employed in similar legislation 2 years earlier in the same subchapter of the Code creates the presumption that no change in meaning was intended. *Zuanich v. Commissioner*, 77 T.C. 428, n. 26 (1981) (quoting *Dickerson, Interpretation and Application of Statutes*, 224 (1975)). 102 T.C. at 354.

Furthermore, after reciting the prior usage of the term in DEFRA, the Eighth Circuit stated:

> Even if there were no property and casualty industry definition of reserve strengthening, a conclusion we have rejected, we see nothing that would prohibit Congress from appropriating the life insurance standard and applying it to a property and casualty provision of the Code. 65 F.3d at 93.

Nevertheless, the Third Circuit concluded that when the same term was used two years later, its meaning was ambiguous. The Third Circuit failed to identify any language in the Act to indicate that Congress intended a different definition. Instead, it derived an inference from language that is not in the statute and relied on ambiguous legislative history.[2] As established by *Rowan*, this Court requires a clear and unambiguous showing of a contrary intent where the statutory term is identical. As noted by the Tax Court and the Eighth Circuit, neither the Act nor the legislative history provides that clear contrary intent.

[2]Section 1023(e)(3)(B) of the Senate version of the Act included a sentence apparently patterned on a sentence in § 216 of DEFRA. As used in DEFRA, the sentence applied only to reserve strengthening on contracts issued in 1983. The sentence in DEFRA had no impact on the general definition of reserve strengthening for purposes of that statute. Since the sentence was not inserted to change the general definition of reserve strengthening in DEFRA, the omission of the sentence in the Act cannot properly support the inference drawn by the Third Circuit that Congress intended a change in the general definition of reserve strengthening for purposes of the Act.

In the opinion below, the Third Circuit accepted Respondent's argument that the term "reserve strengthening" has a commonly understood industry meaning in life insurance, but that no such industry-wide definition exists in P&C insurance. In reaching that conclusion, the Third Circuit reasoned:

> We find it illogical to apply the life insurance definition of reserve strengthening to P&C insurers -- whose reserves are not predicated upon the same actuarial assumptions. If we did so apply it, arguably there would never be any reserve strengthening in the P&C area since interest rates, mortality assumptions and methodologies are not underlying components of the P&C loss reserves. 111 F.3d at 1061.

The Third Circuit's assertion regarding the "components" of P&C reserves is without support in the record and flatly wrong.[3] As a result, the Third Circuit incorrectly stated that P&C insurers do not use methodologies and assumptions in calculating reserves. Although the methodologies and assumptions may differ, the general concept of reserves, whether for a life insurer or a P&C insurer, is the same. The calculation of reserves serves one purpose for all insurers, i.e., identifying the amount of the assets required to be held by an insurer to provide for payment of liabilities to policyholders in the future. As the Tax Court observed in *Western National*:

[3]It is notable that the Third Circuit concluded on the one hand that methodologies and assumptions are not underlying components of P&C loss reserving but on the other hand cited the expert testimony of P&C actuaries whose function is to apply methodologies and assumptions in setting P&C loss reserves.

> In the insurance industry a policy reserve represents a liability; i.e., it represents an obligation to the policyholders. Historically, reserves have been described in PC insurance literature as estimated liabilities for losses and loss adjustment expenses. [footnote omitted.] To some extent, loss reserves are estimates extrapolated from past trends, patterns, averages, and inferences and predictions as to the future. Accordingly, "The reserve simply operates as a charge on so much of an insurance company's assets as must be maintained in order for the company to be able to meet its future commitments under the policies it has issued." [footnote omitted.] The general concept of reserves is the same for life and PC insurance companies. 102 T.C. at 350-351.

The calculation of all insurers' reserves is based on methodologies and assumptions. All insurers make routine changes to reserves. In addition, insurers may make non-periodic changes to reserves if the methodologies and assumptions previously used produce inappropriate results.

Ultimately, the legislative history "provides no persuasive rationale for interpreting the statutory term 'reserve strengthening' in a manner different from industry usage." *Western National*, 65 F.3d at 93. Atlantic's position that reserve strengthening does not apply to all increases to reserves comports with the rationale contained in the legislative history for the reserve strengthening exception to the fresh start. Congress intended to permit P&C insurers a fresh start for normal reserve increases, ones that could not

be "artificial" in nature. H.R. Rep. No. 841, 99th Cong. 2d Sess. (1986) at II-367, reprinted in 1986 U. S. Code Cong. & Admin. News at 4455. However, contrary to this legislative history relating to the reserve strengthening provision, the regulation renders the nature of or reason for a reserve increase irrelevant, because it treats any addition to reserves as reserve strengthening. In this connection, it is important to note that Respondent conceded that Atlantic's reserves were reasonable and that the reserves were determined in accord with Atlantic's past practices. Yet, Respondent determined that Atlantic's routine and reasonable reserve increases constituted "reserve strengthening" under the mechanical test adopted in the regulation.

As in *Rowan*, the legislative history in this case is patently ambiguous and is not sufficient to overcome the presumption to be taken from the use by Congress of the identical term just two years before in a closely analogous statute. Had Congress truly intended to preclude a fresh start for all additions to reserves, it would have done so directly and simply by referring to "all reserve increases" or "all reserve additions" in the statute, rather than using the same highly specialized insurance industry term, "reserve strengthening," it had used just two years before.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Dated: July 22, 1997

Respectfully submitted,

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APPENDIX

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UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 96-7424

ATLANTIC MUTUAL INSURANCE COMPANY,
and Includible Subsidiaries

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellant

Appeal from the United States TaxCourt
(Tax Court No. 93-25767)

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111 F.3d 1056;
97-1 U.S. Tax Cas. (CCH) P50,376; 79
A.F.T.R.2d (P-H) 2272

March 13, 1997, Argued
April 24, 1997, Filed

Before: MANSMANN and LEWIS, Circuit Judges,
and MICHEL, Circuit Judge.*

*** Honorable Paul R. Michel of the United States Court of Appeals for the Federal Circuit, sitting by designation.**

OPINION OF THE COURT

MANSMANN, *Circuit Judge*.

In this appeal, we address the "fresh start" provision of section 1023(e)(3) of the Tax Reform Act of 1986. There Congress permitted property & casualty insurers a one-time forgiveness of income resulting from the change in computing "losses incurred deductions" from undiscounted to a discounted basis as mandated by newly enacted section 846 of the Internal Revenue Code. Specifically, the Commissioner challenges the decision of the Tax Court which invalidated Treas. Reg. § 1.846-3(c) to the extent that it defines all additions to a property & casualty insurer's loss reserves as "reserve strengthening."

We find that the meaning of the term "reserve strengthening" in section 1023(e)(3)(B) of the Tax Reform Act of 1986 is ambiguous. We thus turn to the legislative history to determine Congress' intent. Utilizing the deference principles of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984), we conclude that Treas. Reg. § 1.846-3(c) is based on a permissible construction of the Act and implements the intent of Congress in some reasonable manner. Accordingly, we will reverse the decision of the Tax Court.

I.

The statutory provision at issue is section 1023 of Pub. L. No. 99-514, 100 Stat. 2085, 2399, of the Tax Reform Act of 1986 (TRA 1986), which added new section 846 of the Internal Revenue Code. In enacting section 846, Congress included two relief provisions--the "transition rule" and the "fresh start"--to facilitate a smooth transition to the new rules. *Atlantic Mutual Insurance Co. v. Commissioner*, 71 T.C.M. (CCH) 2154, 2156, 1996 T.C. Memo 75 (1996). The transition rule, set forth in section 1023(e)(2) of TRA 1986, provided that for purposes of computing the losses incurred deduction for 1987, the year-end 1986 reserves would be discounted.[1] Absent this relief provision, section 846 would have required property & casualty ("P&C") insurers to compare undiscounted 1986 reserves with

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[1] Property & casualty companies are taxed pursuant to I.R.C. §§ 831 through 835. Under section 832(a), the taxable income of such a company is defined as the gross income minus allowable deductions. Section 832(c)(4) provides that these deductions include "losses incurred" as defined in section 832(b)(5). Prior to 1986, section 832(b)(5) defined "losses incurred" for all relevant purposes as the amount of "losses paid" during the year plus the increase (or minus the decrease) in "unpaid losses." In practice, the P&C company would deduct the full amount of the estimated total loss in the year of the loss-event, even though the claim might not be paid for several years. When the claim was paid, the company would not receive any additional deduction (assuming that the payment equalled the original estimate) because the payment would be offset by a corresponding reduction it its unpaid-loss reserve.

Prior to TRA 1986, property & casualty insurers received an unsolicited benefit because the tax laws failed to take into consideration the time value of money in calculating the deduction for losses incurred. Congress addressed this problem by enacting I.R.C. § 846 as part of TRA 1986, which provides for the discounting of unpaid losses. The new discounting rules apply to all taxable years commencing after December 31, 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2404.

discounted 1987 reserves for purposes of computing their losses incurred deductions for 1987. As the Tax Court explained, "Such an 'apples-to-oranges' comparison would have significantly reduced the losses incurred deduction for the 1987 tax year." *Id.*

Notwithstanding the relief provided by the transition rule, P&C insurers were still obligated to include in their 1987 taxable income the excess of the undiscounted year-end 1986 loss reserves over the discounted year-end 1986 loss reserves, due to the application of I.R.C. § 481.[2] To avoid the application of section 481, Congress allowed P&C insurers a one-time "forgiveness" of income under the "fresh start" provision of section 1023(e)(3) of TRA 1986. That section provides:

> (3) Fresh Start.--
>
> (A) In General.--Except as otherwise provided in this paragraph, any difference between--
>
> (i) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2), [i.e., without discounting] and

[2] Normally, section 481 would require a taxpayer to recognize the excess as income, because the change in the basis for computing losses incurred deductions from an undiscounted to a discounted methodology constitutes a change in accounting method. In this circumstance, I.R.C. § 481 requires the taxpayer to make an appropriate adjustment to prevent it from obtaining a double deduction created by the change in accounting method.

> (ii) such amount determined with regard to paragraph (2) [i.e., with discounting], shall not be taken into account for purposes of the Internal Revenue Code of 1986.

In substance, the fresh start rule overrides section 481 by excluding from taxable income the difference between the amount of the year-end 1986 undiscounted loss reserves and the discounted amount of such reserves.

Congress anticipated, however, the potential for abuse created by the fresh start provision -- that insurers could manipulate the fresh start provision by inflating their reserves. To prevent such abuse, Congress enacted section 1023(e)(3)(B) to exclude any increases in loss reserves due to "reserve strengthening." Section 1023(e)(3)(B) provides:

> (B) RESERVE STRENGTHENING IN YEARS AFTER 1985.--Subparagraph (A) shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

The meaning of the term "reserve strengthening," as used in section 1023(e)(3)(B), lies at the heart of the controversy before us. We turn now to the particular facts of this case.

II.

The parties fully stipulated to the following facts before the United States Tax Court. Atlantic Mutual Insurance Co. (Atlantic) is the common parent of an affiliated group of corporations whose principal place of

business is located in Madison, New Jersey. Organized in 1842 under the laws of the State of New York as a mutual marine insurer, Atlantic eventually expanded its insurance underwriting activities to include property & casualty insurance. Centennial Insurance Company, a wholly owned subsidiary of Atlantic, is a P&C insurance company included in Atlantic's consolidated income tax return. The Commissioner's notice of deficiency relates to the activities of both Atlantic and Centennial (collectively the "taxpayer").

From 1985 through 1993, the taxpayer filed annual financial statements with the appropriate state insurance departments.[3] P&C insurers are required to report estimates of amounts they expect to pay for losses that have already occurred on the annual statement. These estimates are commonly referred to as "loss reserves" (or simply "reserves").

For the years in issue, case reserves constituted the majority of the taxpayer's loss reserves.[4] The taxpayer set up

[3] Each annual statement was prepared in the format prescribed by the National Association of Insurance Commissioners (NAIC) in order to provide state insurance commissioners with information concerning a P&C insurer's financial condition. The accounting principles on which the NAIC-prescribed annual statement is based generally have been incorporated into the Internal Revenue Code sections applicable to P&C insurers.

[4] In its P&C insurance business, the taxpayer maintained three categories of loss reserves: (1) case reserves, which reflect estimates of amounts to be paid to resolve claims that have been reported to the taxpayer; (2) incurred but not yet reported (IBNR) reserves, which consists of estimates of amounts to be paid to resolve claims statistically presumed to have been incurred but not yet reported to the taxpayer; and (3) loss adjustment expense (LAE) reserves, which reflect estimates of administrative costs to be paid in settling or otherwise resolving claims.

its case reserves by assigning a claims adjuster to examine each reported claim and to estimate the amount, if any, that would be paid to resolve it. For all years at issue, the taxpayer's case reserves totalled $255,655,141 at year-end 1985 and $277,705,661 at year-end 1986.

The Commissioner tested for "reserve strengthening" by applying the formula set forth in Treas. Reg. § 1.846-3(c)(3) to each of the taxpayer's lines of P&C insurance for pre-1986 accident years. Under the formula, the taxpayer's reserves at year-end 1985 were reduced by the claims and the loss adjustment expense (LAE) paid in 1986 with respect to those reserves. To the extent that, at year-end 1986, a reserve was greater than the amount determined under the formula, the excess was treated as a net increase to that reserve account (i.e., "reserve strengthening"). Where, at year-end 1986, a reserve was less than the amount determined under the formula, the difference was treated as a net decrease to that reserve account (i.e., "reserve weakening").

The Commissioner determined that, at year-end 1986, the taxpayer's net "reserve strengthening" totalled $6,552,739. Pursuant to I.R.C. § 846, the Commissioner then discounted the $6,552,739, resulting in an understatement of the taxpayer's 1987 income of $1,339,039. The Commissioner further determined that this understatement caused a deficiency of $519,987 in the taxpayer's 1987 income tax liability and, accordingly, issued a Notice of Deficiency on September 23, 1993. In response, the taxpayer petitioned the Tax Court for a redetermination of the deficiency.

After considering all of the evidence, the Tax Court, on February 22, 1996, issued its decision concluding that the taxpayer was not liable for the asserted deficiency. In reaching this conclusion, the Tax Court held the taxpayer's reserve increases did not constitute "reserve strengthening." *Atlantic Mutual*, 71 T.C.M. at 2159. The Tax Court found that the doctrine of stare decisis obligated it to reach the same result as that obtained in *Western National Mutual Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd* 65 F.3d 90 (8th Cir. 1995), which the court found to be factually indistinguishable from this case. The Commissioner filed this timely appeal.

We have jurisdiction pursuant to 26 U.S.C. § 7482(a) and we exercise plenary review over a legal challenge to the validity of a treasury regulation. *Tate & Lyle, Inc. v. Commissioner*, 87 F.3d 99, 102 (3d Cir. 1996) (citing *Mazzocchi Bus Co., Inc. v. Commissioner*, 14 F.3d 923, 927 (3d Cir. 1994)).

III.

Initially, we must determine whether the meaning of "reserve strengthening" is clear from the plain language of section 1023(e)(3)(B). Our review of an agency's interpretation of a statute that it is empowered to administer is guided by the well-established principles of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984); see also, *Appalachian States Low-Level Radioactive Waste Commission v. O'Leary*, 93 F.3d 103, 108 (3d Cir. 1996). The two-step inquiry in *Chevron* requires us to first determine "whether Congress has directly spoken to the precise question at issue." 467 U.S. at 842. If the intent of

Congress is clear from the plain language of the statute, then our inquiry ends there. If we conclude, however, that Congress is silent or the statute is ambiguous regarding the issue, then the second step of our inquiry is to determine whether the agency's interpretation is based on a permissible construction of the statute. *Id.* at 843.

Addressing the first prong of *Chevron*, we turn to the plain language of section 1023(e)(3)(B). Clearly absent from the text of the statute is any explanation of the meaning of the term "reserve strengthening." We must determine, therefore, whether Congress intended the meaning of reserve strengthening, as used in the life insurance industry, to apply to P&C insurers. The Tax Court, bound by its previous decision in *Western National* which concluded that reserve strengthening as employed in section 1023(e)(3)(B) is a term of art adopted from the life insurance industry, rejected the Commissioner's argument that the meaning of "reserve strengthening" in the P&C insurance industry is ambiguous. We note the distinction, however, that the Commissioner did not present expert witnesses in *Western National*.

The expert testimony here makes clear that the term "reserve strengthening" as used in section 1023(e)(3)(B) is subject to more than one interpretation.[5] Indeed, the Tax

[5] The Commissioner and the taxpayer introduced expert reports in the Tax Court proceedings concerning the meaning of "reserve strengthening" within the P&C industry. The taxpayer's first expert, Irene R. Bass, construed "reserve strengthening" as involving "a one-time (or, at least, unusual and non-periodic), significant change in the assumptions and/or methodologies used to compute the reserves which results in a material change to the relative level of adequacy of the total reserve inventory." Bass conceded, however, that "within the context of the reserve setting process, the term reserve strengthening is not a well-defined PC insurance or actuarial term of art to be found in PC

actuarial, accounting, or insurance regulatory literature." She then opined that "the lack of a well recognized definition of reserve strengthening in PC insurance literature can be attributed to the recursive nature of the reserve setting process and the fact that identification of reserve strengthening is not a requirement of the normal process of setting reserves."

The taxpayer's second expert, W. James MacGinnitie, concurred with the expert opinion of Irene Bass. MacGinnitie then described the concept of reserve strengthening in terms of the adequacy of reserves to satisfy future claims, equating adequacy to reserve strengthening and inadequacy to reserve weakening. He further opined that this determination was one that could not be definitively made until all claims covered by the reserves in question had been finally settled. According to MacGinnitie, in order to determine whether reserve strengthening has occurred one must compare the adequacy of the current reserve for a line of business to the adequacy of a previous reserve for that same line of business.

The Commissioner submitted expert reports prepared by Raymond S. Nichols and Ruth Salzmann. In his report, Nichols stated: "In the property-casualty industry the term 'reserve strengthening' has various meanings, rather than a single universal meaning. However, in determining a property-casualty insurer's underwriting income, 'reserve strengthening' generally refers to a positive amount resulting from the difference between calendar year incurred losses and accident year incurred losses." Nichols opined that "any definition of 'reserve strengthening' that restricts the words to the idiosyncrasies of individual company reserve assumptions and methods will miss the impact of reserve strengthening during underwriting cycles. For this reason alone, the common definition of 'reserve strengthening' does not restrict the meaning to changes in reserve assumptions and methods."

Finally, the Commissioner's second expert, Ruth Salzmann, proffered her definition of reserve strengthening:

"Reserve strengthening (or reserve weakening) is a term used in connection with P/C income statements. It refers to the dollar change in the margin of adequacy in the beginning and ending reserves for unpaid losses for that accounting period. The change can be for whatever reason and for any amount. If ending reserves are more adequate (or less

Court in *Western National* commented that the opinions and testimony of the numerous expert witnesses failed to establish a "universal and precise definition of reserve strengthening." 102 T.C. at 351 n.10. The Tax Court nonetheless found that it was able to glean from the expert testimony the conceptual elements of reserve strengthening as they are commonly used in the insurance industry; it concluded that the concept of reserve strengthening has the same meaning in the context of the P&C and life insurance business. *Id.* at 351 n. 10 and 354. We part company with the Tax Court's holding in this regard.

In determining that "reserve strengthening" has the same meaning for both life and P&C insurers, the Tax Court in *Western National* focused on the fact that Congress, in drafting the language of Subchapter L of the Internal Revenue Code, recognized the unique and highly specialized nomenclature of the insurance industry. Moreover, the court observed that "in enacting the fresh-start provision of the DEFRA [Deficit Reduction Act of 1984], Congress used an industry term of art in a manner consistent with its traditional definition" within the life insurance business.[6] 102

inadequate) than the beginning reserves, there is reserve strengthening in the accounting period and net income is understated; conversely, if ending reserves are less adequate (or more inadequate), there is reserve weakening and net income for the accounting period is overstated."

[6] When Congress enacted the fresh start provision for certain life insurance rules in DEFRA, it specifically defined "reserve strengthening" to include only changes in assumptions and methodology. The Commissioner argued that "reserve strengthening" has a different meaning in the P&C insurance industry. In rejecting this argument, the Tax Court "concluded that 'Congress could not have expected a different quantitative or qualitative meaning for the term' depending on the type of insurer." *Atlantic Mutual*, 71 T.C.M. at 2158 (quoting *Western Nat'l*, 102 T.C. at

T.C. at 359. Accordingly, the Tax Court concluded that "reserve strengthening" was a term of art adopted from the insurance industry. Opining that the legislative history contained contradictory explanations and, in part, supported the Commissioner's regulatory position, the Tax Court nonetheless concluded that Congress intended "reserve strengthening" to be interpreted in a manner consistent with industry usage. *Id.* at 360.[7]

The Tax Court's reliance on cases, revenue rulings and legislation involving life insurance reserves is misplaced. For federal income tax purposes, life insurance companies and P&C insurers are taxed in entirely separate manners. Gross income as well as loss reserves are computed on different bases and assumptions. Actuarial assumptions about interest rates and mortality rates are an integral part of

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354).

[7] The Court of Appeals for the Eight Circuit affirmed the decision of the Tax Court, holding that Treas. Reg. § 1.846-3(c) was invalid to the extent that it defines "reserve strengthening" in a manner contrary to industry usage. *Western National Mutual Ins. Co. v. Commissioner*, 65 F.3d 90, 93 (8th Cir. 1995). In reaching this conclusion, the court of appeals opined that Congress intended to deny the fresh start deduction only to those property & casualty companies that computed their 1986 unpaid loss reserves on the basis of methodologies or assumptions that were different from those employed in calculating the same reserves in prior years. *Id.* at 93. As a corollary to this conclusion, the court of appeals also found that the term "reserve strengthening" was not ambiguous. *Id.* (footnote omitted). Accordingly, the court held that it was not required to consider the legislative history to divine the meaning of "reserve strengthening." *Id.* The court of appeals nonetheless proceeded to examine the legislative history, "out of an abundance of caution," and determined that it failed to provide persuasive rationale for interpreting "reserve strengthening" contrary to industry usage. *Id.* We respectfully disagree.

computing future losses which form the basis of the loss reserves in life insurance. On the other hand, P&C loss reserves are determined primarily based on past claims experience and the judgments of the individual claims adjusters.

In the life insurance industry, reserve strengthening constitutes an unusual increase resulting generally from a change in one of the fundamental reserve assumptions (i.e., interest rate, mortality rate, method), as contrasted to normal increases in life insurance reserves, which result from the receipt of additional premiums or accrued interest. We find it illogical to apply the life insurance definition of reserve strengthening to P&C insurers -- whose reserves are not predicated upon the same actuarial assumptions. If we did so apply it, arguably there would never be any reserve strengthening in the P&C area since interest rates, mortality assumptions and methodologies are not underlying components of the P&C loss reserves. The Commissioner makes a persuasive argument that the differences between life insurance and P&C loss reserves "render the wholesale importation of life insurance concepts into the P&C unpaid-loss reserve area quite dubious at best."

The revenue rulings cited by the Tax Court and the taxpayer[8] are inapposite to the issue of reserve strengthening by P&C insurers. These revenue rulings address life insurance reserves maintained by P&C insurers who also write life insurance. In both rulings, the taxpayers requested advice on how to compute life insurance reserves in a given factual situation. The rulings do not define reserve

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[8] Rev. Rul. 65-240, 1965-2 C.B. 236, Rev. Rul. 78-354, 1978-2 C.B. 190.

strengthening with respect to P&C loss reserves in the context of life insurance reserves.

Moreover, we find that the reserve strengthening provision in DEFRA differs from the provision in TRA 1986 and, thus, supports the Commissioner's argument that Congress did not intend to import the life insurance definition of reserve strengthening into section 1023(e)(3)(B). The 1984 statute specifically links reserve strengthening by life insurance companies to changes in the reserve practice used on the most recent annual financial statement. A similar limitation was contained in the Senate amendment to section 1023(e)(3)(B) but was intentionally eliminated by the Conference Committee. The Supreme Court addressed a similar situation involving the RICO statute and held:

> Where Congress includes particular language in one section of a statute, but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion. Had Congress intended to restrict § 1963(a)(1) to an interest in an enterprise, it presumably would have done so expressly as it did in the immediately following subsection (a)(2). * * * The short answer is that Congress did not write the statute that way. We refrain from concluding here that the differing language in the two subsections has the same meaning in each. We would not presume to ascribe this difference to a simple mistake in draftsmanship.

Russello v. United States, 464 U.S. 16, 23-24, 78 L. Ed. 2d 17, 104 S. Ct. 296 (1983). Accordingly, the reserve

strengthening provision of DEFRA does not support the taxpayer's position here.

Given the lack of an explicit statutory definition of reserve strengthening, the conflicting definitions of reserve strengthening provided by the expert witnesses, and our finding that the meaning attributed to reserve strengthening in the life insurance industry is not applicable to P&C insurers, we conclude that the meaning of "reserve strengthening" is ambiguous. Accordingly, we find the Tax Court erred as a matter of law in holding that the meaning of reserve strengthening in section 1023(e)(3)(B) was plain.

IV.

Because we find the meaning of the term "reserve strengthening" ambiguous with regard to P&C insurers, we turn to the second prong of the *Chevron* inquiry. In so doing, we are required to take a deferential approach to ascertaining whether the agency's interpretation is a permissible one. *Appalachian States Low-Level Radioactive Waste Commission v. O'Leary*, 93 F.3d at 110. Thus, "we must determine 'whether the regulation harmonizes with the plain language of the statute, its origin, and purpose. So long as the regulation bears a fair relationship to the language of the statute, reflects the views of those who sought its enactment, and matches the purpose they articulated, it will merit deference.'" *Id.* (quoting *Sekula v. F.D.I.C.*, 39 F.3d 448, 452 (3d Cir. 1994)).

We begin our analysis by turning to the legislative history of section 1023(e)(3)(B). The provision requiring P&C insurers to discount their loss reserves originated in a House bill. H.R. 3838, 99th Cong., 1st Sess., § 1021-1027

(1985). In the Senate version, the provision was amended to include the fresh start provision as well as the exclusion for reserve strengthening. The pertinent language of the Senate bill states:

> (3) FRESH START.--
>
> (A) IN GENERAL.--Except as otherwise provided in this paragraph, any difference between the amount determined to be the unpaid losses and expenses unpaid for the year preceding the first taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2), and such amount determined with regard to paragraph (2), shall not be taken into account for purposes of the Internal Revenue code of 1954.
>
> (B) RESERVE STRENGTHENING AFTER MARCH 1, 1986. [The fresh start provision] shall not apply to any reserve strengthening reported for Federal income tax purposes after March 1, 1986, for a taxable year beginning before January 1, 1987, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986. ***The preceding sentence shall not apply to the computation of reserves on any contract if such computation employs the reserve practice used for purposes of the most recent annual statement filed on or before March 1, 1986, for the type of contract with respect to which reserves are set up.***

H.R. 3838, 99th Cong., 2d Sess., § 1022(e) (as reported by the Senate Finance Committee, May 29, 1986) (emphasis

added). The Senate Finance Committee explained this provision as follows:

> Any reserve strengthening after March 1, 1986, is to be treated as reserve strengthening for the first taxable year beginning after December 31, 1986. The committee intends that any adjustments to reserves that are attributable to changes in reserves on account of changes in the basis for computing the reserves (i.e., reserve strengthening or reserve weakening) in a taxable year beginning before January 1, 1987, are not taken into account in determining taxable income after the effective date.

S. Rep. No. 99-313, 1986-3 C.B. (Vol. 3) 510.

The Conference Committee reconciled the differences between the House and Senate versions of H.R. 3838 by eliminating the last sentence of the Senate amendment (section 1022(e)(3)(B)) that linked reserve strengthening to changes in reserve setting practices. Although the final bill did not define "reserve strengthening," the Conference Committee report accompanying the final bill did, in fact, provide a definition of that term. The Conference Committee's definition, which was more expansive than that contained in the Senate Finance Committee report, reads as follows:

> Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the

> assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves. This provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision.

H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess., at II-367 (1986), reprinted in 5 U.S.C.C.A.N. 4075, 4455 (1986).[9] Further evidence of the Conference Committee's expansion of the definition of reserve strengthening is found in Senator Wallop's criticism of the Committee's action:

> Presumably, the intent is to prevent insurers from artificially increasing the opening reserve in order to increase income forgiven under fresh start. Implicit in this provision is the notion that reserve strengthening actions taken by insurance companies during 1986 for prior accident years is heavily motivated by the desire to avoid Federal income taxes. Nothing could be further from the truth. While it certainly can be acknowledged that increases in reserves decrease an insurance company's Federal tax burden, there are substantial and legitimate nontax

[9] The Tax Court here acknowledged that the Conference Committee's definition of reserve strengthening was more expansive than that contained in the Finance Committee report. *Atlantic Mutual*, 71 T.C.M. at 2157.

> reasons[10] for increasing the provision for unpaid losses in prior accident years. . . .
>
> . . .
>
> The reserve strengthening definition as currently written in the conference report is arbitrary and inconsistent with one of the goals of tax reform, that is, fostering positive behavioral response from corporate and individual taxpayers toward the Federal tax system.
>
> The Senate bill's reserve strengthening provision was fair. The Internal Revenue Service, as it does under current law, would combat abusive reserving practices. The conference modification substitutes a simplistic, cookbook approach that is entirely inappropriate and will likely create tensions causing companies to underreserve to the potential detriment of their policyholders.

132 Cong. Rec. 32625 (daily ed. October 16, 1986).

[10] Senator Wallop offered two legitimate nontax reasons for increasing reserves: (1) reserves are based on estimates computed from statistical models that are subject to error and, thus, must be reevaluated from time to time; and (2) P&C insurers have historically been underreserved and reserve strengthening for them occurs is as a normal part of doing business.

Treas. Reg. § 1.846-3(c) (1992),[11] which is predicated on the definition of "reserve strengthening" set forth in the Conference Committee report, provides in pertinent part:

> **(c) Rules for determining the amount of reserve strengthening (weakening)--(1) In general.** The Amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in 1986. For purposes of [the fresh start], the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. The amount of reserve strengthening for an unpaid loss reserve may not exceed the amount of the reserve, including any undiscounted strengthening amount, as of the end of the last taxable year beginning before January 1, 1987. For purposes of this section, an "unpaid loss reserve" is the aggregate of the unpaid loss estimate for losses (whether or not reported) incurred in an accident year of a line of business.

[11] In 1988, the IRS issued a notice of forthcoming regulations regarding the application of section 1023(e)(3)(B). I.R.S. Notice 88-100, 1988-2 C.B. 439. Proposed regulations were issued in 1991, Proposed Treas. Reg. § 1.846-3, 56 F.R. 20161 (May 2, 1991), and eventually, final regulations were promulgated on September 4, 1992.

> . . .
>
> **(3) Accident years before 1986--(i) In general.** For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of that taxable year exceeds (is less than)--
>
> (A) The reserve at the end of the immediately preceding taxable year; reduced by
>
> (B) Claims paid and loss adjustment expenses paid ("loss payments") in the taxable year beginning in 1986 with respect to losses that are attributable to the reserve. . . .

In the explanation accompanying the final regulations, the IRS noted its reason for not adopting the commentators' suggested alternatives to the mechanical test:

> Congress did not limit the imposition of the reserve strengthening rule to tax motivated transactions. The legislative history indicates that for purposes of the fresh start adjustment the term "reserve strengthening" includes "all additions to reserves attributable to an increase in an estimate of reserves established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the assumptions (other than changes in the assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or

unallocated additions to loss reserves". See 2 H.R. Conf. Rep. 841, 99th Cong., 2d Sess. II-367 (1986), 1986-3 (Vol. 4) C.B. 367. Thus, Congress adopted an expansive and mechanical definition of reserve strengthening that is reflected in the final regulations.

1992-2 C.B. 146, 148.

A close examination of Treas. Reg. § 1.846-3(c)(3) reveals that virtually all additions to reserves constitute reserve strengthening. The regulation also contains two narrow exceptions, neither of which applies here. The regulation can be reconciled with the Conference Committee's description of reserve strengthening which is all-inclusive: "all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year). . . ." H.R. Conf. Rep. No. 99-841. As it applies to reserve strengthening for pre-1986 accident years, Treas. Reg. § 1.846-3(c) does not contradict the Conference explanation and is somewhat more generous to the taxpayer by providing two, albeit narrow, exceptions.

Our remaining inquiry is whether the regulation harmonizes with the articulated purpose of section 1023(e)(3)(B). The purpose of the reserve strengthening exception, as articulated by the Conference Committee, is "to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision." The Commissioner and the taxpayer disagree as to the meaning to be ascribed to the Committee's use of the word "artificially" in delineating the purpose of the limitation. This dispute stems from the Tax Court's statement, in *Western National*, that the word "artificial" suggests a

dichotomy between routine, normal additions to reserves and irregular or nonperiodic increases attributable to changes in actuarial assumptions or methodology. The Tax Court's analysis, however, cannot be reconciled with the Conference Committee's broad definition of reserve strengthening which includes normal additions. Thus, the Conference Committee used the term "artificial" in a general sense, to refer to any increases in the reserves other than those resulting from the difference attributed to the discounting of reserves. To accept the Tax Court's construction of "artificial" would mean that the Conference Committee intentionally contradicted itself one sentence later.

In light of the above discussion, we cannot say that Treas. Reg. § 1.846-3(c)(3) is inconsistent with Congress' intent, as evidenced by the Conference report. Accordingly, we find that Treas. Reg. § 1.846-3(c) meets the second prong of the *Chevron* test and, thus, constitutes a valid interpretation of section 1023(e)(3)(B).

The taxpayer makes several arguments[12] suggesting that the application of the Treasury regulation will cause anomalous results. These involve unrealistic assumptions about the size and number of claims. We agree with the Commissioner that, to the extent the mechanical test is

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[12] The taxpayer further contends that despite numerous comments during the promulgation process as to the proposed regulation's infirmities, the Commissioner went forward in adopting a mechanical test for determining the amount of reserve strengthening. In particular, the taxpayer takes issue with the test's reserve-by-reserve approach as opposed to a claim-by-claim calculation. The Conference Report, however, supports a reserve-by-reserve approach ("all additions to *reserves* attributable to an increase in an estimate of a *reserve* established for a prior accident year.") (emphasis added).

flawed, the taxpayer should seek relief from Congress and not the courts. "Judges cannot override the specific policy judgments made by Congress in enacting the statutory provisions with which we are here concerned." *United States v. Sotelo*, 436 U.S. 268, 279, 56 L. Ed. 2d 275, 98 S. Ct. 1795 (1978). We must not focus on the Act's policy, but rather, on what Congress intended in enacting the statute.[13] *Id.* at 280.

The Treasury Department considered proposed alternatives to Treas. Reg. § 1.846-3 but ultimately concluded that the interpretation was consistent with Congress' intent. As the Supreme Court observed in *United States v. Correll*, 389 U.S. 299, 306-07, 19 L. Ed. 2d 537, 88 S. Ct. 445 (1967):

> Alternatives to the Commissioner's . . . rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. In this area of limitless factual variations, "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.

[13] We agree with the Commissioner that the regulation need not provide the "perfect solution in every case to be valid." Indeed, in *Mourning v. Family Publications Services, Inc.*, 411 U.S. 356, 371, 36 L. Ed. 2d 318, 93 S. Ct. 1652 (1973), the Court held the fact that another remedial provision might be preferred irrelevant to determining whether the agency overstepped its authority. The Court stated: "We have consistently held that where reasonable minds may differ as to which of several remedial measures should be chosen, courts should defer to the informed experience and judgment of the agency to whom Congress delegated appropriate authority." *Id.* at 371-72 (citations omitted).

(footnote and citation omitted). Because Treas. Reg. § 1.846-3(c) implements the intent of Congress in some reasonable manner, the Tax Court erred in holding that the regulation was invalid.

V.

For the reasons set forth above, we will reverse the decision of the Tax Court.

UNITED STATES TAX COURT

Docket No. 25767-93.

ATLANTIC MUTUAL INSURANCE COMPANY AND INCLUDIBLE SUBSIDIARIES,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

T.C. Memo 1996-75;
71 T.C.M. (CCH) 2154

February 22, 1996, Filed

MEMORANDUM OPINION

FOLEY, Judge: Respondent determined a deficiency of $519,987 in petitioners' Federal income tax for the 1987 taxable year as a result of alleged "reserve strengthening". Under the Tax Reform Act of 1986 (TRA '86), Pub. L. 99-514, sec. 1023, 100 Stat. 2085, 2404, any increases in the loss reserves maintained by property and casualty insurance companies that constitute "reserve strengthening" do not qualify for a one-time tax benefit. In this case, respondent contends that the term "reserve strengthening" refers to all increases in loss reserves, while petitioners maintain that the term refers to only those increases in loss reserves that are attributable to changes in computation methods or assumptions. Respondent's interpretation of the term "reserve

strengthening" is set forth in section 1.846-3(c), Income Tax Regs. The deficiency in this case is based on that regulation. In light of this Court's decision in *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), affd. 65 F.3d 90 (8th Cir. 1995), we hold for petitioners.

Background

The facts have been fully stipulated under Rule 122 of the Tax Court Rules of Practice and Procedure and are so found. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the year in issue.

Atlantic Mutual Insurance Co. (Atlantic) is the common parent of an affiliated group of corporations within the meaning of section 1504(a). Atlantic filed consolidated income tax returns on behalf of the group for all relevant years. At the time the petition in this case was filed, Atlantic's principal place of business was in Madison, New Jersey.

Atlantic was organized in 1842 under the laws of the State of New York as a mutual marine insurer. Over the years, Atlantic has expanded its insurance underwriting activities to include most lines of insurance business available to a property and casualty (P&C) insurer. Centennial Insurance Co. (Centennial), a wholly owned subsidiary of Atlantic, is a P&C insurance company included in Atlantic's consolidated return. Because respondent's notice of deficiency relates to the activities of both Atlantic and Centennial, we will refer to the two corporations together as petitioner.

From 1985 through 1993, petitioner filed an annual statement with the insurance department of each State in which petitioner was licensed to conduct insurance business. Each annual statement was prepared in the format prescribed by the National Association of Insurance Commissioners (NAIC). A primary purpose of the annual statement is to provide State insurance commissioners with information concerning a P&C insurer's financial condition. The accounting principles on which the NAIC-prescribed annual statement is based generally have been incorporated into the Internal Revenue Code sections applicable to P&C insurers.

On the annual statement, P&C insurers are required to report estimates of amounts they expect to pay to cover losses that have already occurred. These estimates are commonly referred to as "loss reserves" (or simply "reserves"). Petitioner maintained three categories of loss reserves: (1) Case reserves, which reflect estimates of amounts to be paid to resolve claims that have been reported to petitioner; (2) incurred but not yet reported (IBNR) reserves, which reflect estimates of amounts to be paid to resolve claims statistically presumed to have been incurred but not yet reported to petitioner; and (3) loss adjustment expense (LAE) reserves, which reflect estimates of administrative costs to be paid in settling or otherwise resolving claims. For the years in issue, case reserves constituted the majority of petitioner's loss reserves.

Petitioner established its case reserves by assigning a claims adjuster to examine each reported claim and estimate the ultimate amount, if any, that would be paid to resolve it. Case reserves simply comprised the aggregate of those estimates. Overall, petitioner's case reserves totaled

$255,655,141 at yearend 1985 and $277,705,661 at yearend 1986.

Petitioner established its IBNR reserves by applying a "counts and averages" methodology to each line of insurance business. Under this method, petitioner computed its IBNR reserves by multiplying (1) the number of claims that it presumed would be reported after the accident year by (2) the average cost it projected to resolve each late-reported claim. Petitioner based its estimate of these numbers on its experience in prior accident years and then adjusted the results to reflect actuarial quarterly reviews of the loss reserves for the preceding year. Senior management had discretion in determining the size of the adjustments. Management made downward adjustments to petitioner's IBNR reserves of $1,200,000 for 1985 and $100,000 for 1986. Overall, petitioner's IBNR reserves totaled $93,713,687 at yearend 1985 and $111,708,986 at yearend 1986.

Petitioner established its LAE reserves through a combination of individual case estimates, formulas, and judgmental factors. To arrive at an estimate of LAE reserves, petitioner calculated the ratio of LAE it paid during a preceding 3-year period to total losses it paid during the same period and used that ratio as a component in certain formulas. Petitioner maintained two categories of LAE reserves: (1) Allocated loss adjustment expenses (ALAE), which consisted of expenses assignable to individual claims (e.g., legal fees and costs), and (2) unallocated loss adjustment expenses (ULAE), which consisted of expenses not assignable to individual claims (e.g., rent allocable to the claims department). Petitioner used different formulas to compute each category of its LAE reserves. Petitioner's

management then adjusted the ALAE (but not the ULAE) estimate based on quarterly loss and LAE reviews. Overall, petitioner's LAE reserves totaled $72,317,450 at yearend 1985 and $84,066,519 at yearend 1986.

Respondent tested for "reserve strengthening" by applying the formula set forth in section 1.846-3(c)(3), Income Tax Regs., to each of petitioner's lines of insurance business for pre-1986 accident years. Under the formula, petitioner's reserves at yearend 1985 were reduced by the claims and the LAE paid in 1986 with respect to those reserves. To the extent that, at yearend 1986, a reserve was greater than the amount determined under the formula, the excess was treated as a net increase to that reserve account (i.e., "reserve strengthening"). To the extent that, at yearend 1986, a reserve was less than the amount determined under the formula, the difference was treated as a net decrease to that reserve account (i.e., "reserve weakening").

Respondent determined that, at yearend 1986, petitioner's "reserve strengthening" totaled the following amounts:

Line of Business	Reserve Strengthening (Weakening)
Auto liability	($10,559,423)
Other liability	(1,279,374)
Workers' compensation	4,691,659
Multiple peril	15,585,877
Schedule O[1] (1985)	(3,870,000)
Schedule O (pre-1985)	1,984,000
Net total	6,552,739

[1] Schedule O, a part of the annual statement filed with the National Association of Insurance Commissioners, contains combined loss data on several lines of insurance business with respect to which claims are filed and settled within a relatively short period.

Respondent then discounted, pursuant to section 846, the amount determined as "reserve strengthening" in order to calculate the effect on petitioner's gross income[1]. After discounting the amounts shown in the foregoing chart, respondent determined that petitioner understated its 1987 income as follows:

[1] For a discussion of sec. 846 and discounting generally, see sec. I.A., "The Change from Undiscounted to Discounted Reserve Accounting", in the Discussion section of this opinion.

Line of Business	Income Adjustment
Auto liability	($1,211,842)
Other liability	(309,970)
Workers' compensation	1,211,652
Multiple peril	1,783,897
Schedule O (1985)	(239,446)
Schedule O (pre-1985)	104,748
Net total	1,339,039

Respondent further determined that this $1,339,039 understatement of petitioner's 1987 income resulted in a $519,987 understatement of petitioner's 1987 income tax liability.

Discussion

I. *Overview*

TRA '86 substantially revised the rules that govern the taxation of P&C insurance companies by requiring P&C insurers to discount loss reserves for purposes of section 832(b)(5) (discussed below). The change from undiscounted to discounted methodology eliminated a tax benefit attributable to the time value of money. It also required taxpayers to change their accounting methods. To facilitate a smooth transition to the new rules, Congress included two relief provisions in the legislation--the "transition rule" and the "fresh start".

A. *The Change From Undiscounted to Discounted Reserve Accounting*

Section 832(c)(4) permits P&C insurers to deduct "losses incurred", as defined in section 832(b)(5), in each taxable year. Under section 832(b)(5), losses incurred are defined as the excess of (1) the sum of (a) losses paid during the current tax year and (b) yearend reserves in the current tax year over (2) yearend reserves in the preceding tax year. Prior to 1986, section 832 provided P&C insurers with a significant tax benefit. It permitted them to take current deductions for future payments without requiring them to make any adjustments for the time value of money. To eliminate this benefit, TRA '86 added section 846. Section 846 requires reserves for taxable years beginning after December 31, 1986, to be discounted and thus reduces the losses incurred deduction (as calculated under section 832(b)(5)) to reflect the time value of money.

Without a relief provision, section 846 would have required P&C insurers to compare undiscounted 1986 reserves with discounted 1987 reserves for purposes of computing their losses incurred deductions for 1987. Such an "apples-to-oranges" comparison would have significantly reduced the losses incurred deduction for the 1987 tax year. To illustrate, assume a P&C insurer had loss reserves of $100 million at the end of 1986 and $125 million at the end of 1987. But for section 846, the losses incurred deduction attributable to unpaid losses would have been $25 million (i.e., $125 million - $100 million). If pursuant to section 846 the $125 million of reserves at the end of 1987 were discounted to $110 million, the P&C insurer's losses incurred deduction would have been reduced from $25 million to $10 million (i.e., $110 million - $100 million).

To address this problem, Congress included a transition rule in TRA '86. The transition rule provided that, for purposes of computing the losses incurred deduction at yearend 1987, 1986 reserves also would be discounted. TRA '86 sec. 1023(e)(2), 100 Stat. 2404. As a result of this transition rule, discounted 1987 reserves were compared with discounted 1986 reserves in computing the losses incurred deduction for the 1987 taxable year.

B. *The Application of Section 481*

Even with the transition rule described above, P&C insurance companies remained subject to adverse tax consequences due to the application of section 481. When a taxpayer changes its method of accounting, section 481 generally requires that the taxpayer make adjustments to prevent amounts from being duplicated in or omitted from its taxable income. Compliance with the requirement that P&C insurers change the basis for computing their losses incurred deductions from an undiscounted to a discounted methodology constituted a change in accounting method. Thus, section 481 would have required P&C insurers to recognize as income the difference between (1) the undiscounted amount of loss reserves, as of yearend 1986, included in the computation of the losses incurred deduction for 1986 and (2) the discounted amount of such loss reserves.

To avoid triggering section 481 adjustments, Congress provided P&C insurers with a "fresh start" pursuant to section 1023(e)(3) of TRA '86. TRA '86 sec. 1023(e)(3)(A), 100 Stat. 2404. This section provides as follows:

(3) Fresh start.--

(A) In general.--Except as otherwise provided in this paragraph, any difference between--

(i) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2) [i.e., without discounting], and

(ii) such amount determined with regard to paragraph (2) [i.e., with discounting], shall not be taken into account for purposes of the Internal Revenue Code of 1986.

In essence, the fresh start provision overrode section 481 by excluding from taxable income the difference between the amount of the yearend 1986 undiscounted loss reserves and the discounted amount of such reserves. In its report, the Committee of Conference (conference committee) described the effect of the fresh start provision as a "forgiveness of income". H. Conf. Rept. 99-841 (Vol. II), at II-367 (1986), 1986-3 C.B. (Vol. 4) 1, 367.

The fresh start provision, however, created the potential for abuse. Because the difference between the undiscounted and discounted loss reserves as of yearend 1986 is excluded from taxation, P&C insurers could manipulate the fresh start provision by inflating their reserves. To prevent this abuse, Congress excluded "reserve strengthening" from the fresh start.

TRA '86, however, did not define "reserve strengthening". Generally, a P&C insurer's loss reserves may increase due to either of two factors: (1) Additions required to fund existing and increasing obligations under policies in force, or (2) additions required when a method or assumption used in calculating reserves is changed to produce higher reserves. As discussed in more detail below, respondent argues that "reserve strengthening" encompasses both types of additions, while petitioner contends that the term refers solely to additions resulting from changes in reserving methods or assumptions.

II. *The Statute, Legislative History, and Regulations*

The House of Representatives initiated the provision requiring P&C insurers to discount their loss reserves. H.R. 3838, 99th Cong., 1st Sess. secs. 1021-1027 (1985). The Senate amended the House's proposal to include both (1) the fresh start provision and (2) the exclusion of "reserve strengthening" from the fresh start. See S. Rept. 99-313, at 510 (1986), 1986-3 C.B. (Vol. 3) 1, 510. Ultimately, the conference committee substantially revised the "reserve strengthening" language contained in both the Senate bill and in the accompanying Senate Finance Committee report.

The Senate bill contained the following provision:

> (B) Reserve Strengthening After March 1, 1986.-- * * * [the fresh start provision] shall not apply to any reserve strengthening reported for Federal income tax purposes after March 1, 1986, for a taxable year beginning before January 1, 1987, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December

> 31, 1986. The preceding sentence shall not apply to the computation of reserves on any contract if such computation employs the reserve practice used for purposes of the most recent annual statement filed on or before March 1, 1986, for the type of contract with respect to which such reserves are set up. [H.R. 3838, 99th Cong., 2d Sess., sec. 1022(e)(3)(B), as reported by the Senate Finance Committee on May 29, 1986.]

The Finance Committee report stated that "reserve strengthening" consisted of "any adjustments to reserves that are attributable to changes in reserves on account of changes in the basis for computing reserves (i.e., reserve strengthening or reserve weakening) in a taxable year beginning before January 1, 1987". S. Rept. 99-313, *supra* at 510, 1986-3 C.B. (Vol. 3) at 510.

The differences between the House and Senate versions of H.R. 3838 were reconciled by the conference committee. The final bill adopted by the conference committee and enacted into law did not define "reserve strengthening". It provided as follows:

> (B) Reserve Strengthening In Years After 1985.-- * * * [the fresh start provision] shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986. [H. Conf. Rept. 99-841 (Vol. I), at I-338 (1986), 1986-3 C.B. (Vol. 1) 1, 321.]

The conference committee report accompanying the final bill, however, did provide a definition of "reserve strengthening" and, in fact, provided a more expansive definition of the term than that contained in the Finance Committee report. The conference committee report stated:

> Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves. This provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision. [H. Conf. Rept. 99-841 (Vol. II), *supra* at II-367, 1986-3 C.B. (Vol. 4) at 367.]

In 1992, the U.S. Treasury Department issued regulations under section 846 that are based upon the definition of "reserve strengthening" contained in the conference committee report. Section 1.846-3(c), Income Tax Regs., provides in relevant part:

> (c) Rules for determining the amount of reserve strengthening (weakening).--(1) In general. The amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in

> 1986. For purposes of * * * [the fresh start], the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. The amount of reserve strengthening for an unpaid loss reserve may not exceed the amount of the reserve, including any undiscounted strengthening amount, as of the end of the last taxable year beginning before January 1, 1987. For purposes of this section, an "unpaid loss reserve" is the aggregate of the unpaid loss estimates for losses (whether or not reported) incurred in an accident year of a line of business.
>
> * * * * * * *
>
> (3) Accident years before 1986. (i) In general. For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of the taxable year exceeds (is less than)--
>
> (A) The reserve at the end of the immediately preceding taxable year; reduced by
>
> (B) Claims paid and loss adjustment expenses paid ("loss payments") in the taxable year beginning in 1986 with respect to losses that are attributable to the reserve. * * *

III. *The Western National Decision*

In *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), a Court-reviewed decision, this Court considered facts virtually identical to those presented in this case. The Court ruled for the taxpayer, holding that section 1.846-3(c), Income Tax Regs., is invalid to the extent that it treats all net additions in 1986, to pre-1986 loss reserves, as "reserves strengthening". As in the present case, the taxpayer in *Western National* had a higher loss reserve balance, for pre-1986 years, at yearend 1986 than at yearend 1985, but had not changed its reserve assumptions or methodology in computing that balance. The Commissioner argued that all increases in reserves constituted "reserve strengthening" and that the taxpayer's increase therefore should have been excluded from the fresh start. In rejecting the Commissioner's position, the Court cited the following six factors:

> (1) The statute is not ambiguous and uses a term of art in a portion of the Internal Revenue Code which has been specially designed for a particular industry and generally contains industry jargon; (2) the legislative history materials are internally contradictory in that there are references to all increases to reserves and explanations regarding artificial increases or a specific type of increase; (3) the regulatory definition of the term "reserve strengthening" does not comport with insurance industry usage; (4) the regulatory definition of the term "reserve strengthening" does not harmonize with its congressional use 2 years earlier in related and parallel statutes involving life, rather than PC, insurance companies; (5) the regulatory approach would result in anomalous results; and (6) the traditional industry definition of the term comports with the concept that Congress was attempting to limit any attempts by taxpayers to take advantage of the fresh-start provisions by means of artificial increases to reserves. * * * [*Id.* at 360-361.]

The Court placed particular emphasis on several of these factors. It stated that subchapter L, which sets forth rules governing the taxation of insurance companies, "is a highly specialized portion of the Internal Revenue Code which is replete with the unique nomenclature of the insurance industry." *Id.* at 342-343. The Court acknowledged that the statute did not provide a definition of "reserve strengthening" but found that the term refers to "a change in the formula or mechanism for calculating a reserve". *Id.* at 352. Moreover, the Court noted, Congress had defined the term as including only changes in assumptions or methodology when it enacted certain life insurance rules and a fresh start provision in the Deficit Reduction Act of 1984, Pub. L. 98-369, sec. 216(b), 98 Stat. 494, 758. *Id.* at 353. In rejecting the Commissioner's argument that "reserve strengthening" has a different meaning in the P&C insurance industry than in the life insurance industry, the Court concluded that "Congress could not have expected a different quantitative or qualitative meaning for the term" depending on the type of insurer. *Id.* at 354.

Although section 1.846-3(c), Income Tax Regs., provided a definition of "reserve strengthening" consistent with the conference committee report, the Court in essence concluded that priority must be accorded to the statute, which "contains a term of art used in an unconditional manner." *Id.* at 355. Moreover, the Court noted, the

conference committee report states that the fresh start was "intended to prevent taxpayers from artificially increasing the amount of income that is forgiven". *Id.* at 356 n.19 (quoting H. Conf. Rept. 99-841 (Vol. II), *supra* at II-367, 1986-3 C.B. (Vol. 4) at 367). The Court concluded that the word "artificially" refers to changes in assumptions or methodology. *Id.* By contrast, the taxpayer in *Western National* merely had made routine adjustments to its loss reserves based on its past reserving practices. *Id.* at 357.

The Court of Appeals for the Eighth Circuit affirmed the Tax Court's decision in *Western National*. It concluded that the term "reserve strengthening" when used in the life insurance industry refers to reserve increases attributable to changes in computational methods or assumptions. *Western Natl. Mut. Ins. Co. v. Commissioner*, 65 F.3d 90, 92-93 (8th Cir. 1995). The court rejected the Commissioner's argument that the term's meaning in the P&C insurance industry is ambiguous. *Id.* at 93. Having decided that the meaning of "reserve strengthening" is clear in the industry, the court further concluded that the legislative history underlying the provision is not controlling. *Id.* Nevertheless, the court stated that it had reviewed the legislative history "out of an abundance of caution" and found "'no persuasive rationale for interpreting the statutory term "reserve strengthening" in a manner different from industry usage.'" *Id.* (quoting *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. at 355).

IV. *Respondent's Position*

Respondent urges this Court to reconsider its holding in *Western National*. Respondent in the present case, as in *Western National*, maintains that "reserve strengthening"

encompasses all net additions in 1986 to pre-1986 loss reserves. Respondent acknowledges that, in the life insurance industry, the term "reserve strengthening" has the meaning petitioner ascribes to it. Respondent continues to contend, however, that the term's meaning in the P&C insurance industry is ambiguous.

Respondent has presented expert testimony which indicates that the term is subject to more than one interpretation. One expert opined that the regulation's definition provided a valid measurement of "reserve strengthening". Another expert opined that the regulation's definition, while not technically accurate, was consistent with a common usage of the term in nonactuarial reporting. Moreover, respondent notes that the conference committee report's definition of "reserve strengthening" is fully consistent with her position. The report stated:

> Reserve strengthening is considered to include *all* additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year * * * and *all* additions to reserves resulting from a change in the assumptions * * * as well as *all* unspecified or unallocated additions to loss reserves. * * * [H. Conf. Rept. 99-841 (Vol. II), *supra* at II-367, 1986-3 C.B. (Vol. 4) at 367; emphasis added.]

Respondent also addresses two points made in *Western National* regarding the legislative history of "reserve strengthening". First, respondent argues that the Court's view--that the conference committee report "conflicts" with other portions of the legislative history--does not take into account the evolution of the

statute. Conference committees reconcile differences between House and Senate versions of legislation and write the final legislation that is enacted into law. In respondent's view, therefore, the decision of the conference committee to reject the language contained in the Senate report does not create a "conflict" but instead provides the rationale for the final legislation.

Second, respondent addresses the Court's concern that the conference committee's definition of "reserve strengthening" is internally contradictory. The Court found that the conference committee's definition of the term is "broader than necessary to accomplish the stated purpose of preventing abuse from artificial increases". *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. at 350. Respondent contends that this point does not undermine her position, because Congress sometimes finds it expedient to adopt bright-line rules that do not in every case effectuate congressional intent precisely.

Because respondent believes that the statute is ambiguous and the regulations in issue effectively implement the conference committee's definition of "reserve strengthening", she maintains that the regulations reflect a reasonable and permissible construction of the statute.

Respondent argues in the alternative that, if we hold that "reserve strengthening" includes only those increases in reserves attributable to changes in methodology or assumptions, we should determine a lesser deficiency, because all or some of petitioner's additions to its IBNR and LAE reserves resulted from management's discretionary adjustments.

V. *Petitioner's Position*

Consistent with this Court's holding in *Western National*, petitioner maintains that the term "reserve strengthening" is an insurance industry term of art with a clearly understood technical meaning. As used in the insurance industry, petitioner argues, "reserve strengthening" encompasses only those increases in loss reserves that are attributable to nonperiodic, significant changes in the assumptions and/or methodologies used to establish such loss reserves. Because the increase in petitioner's 1986 reserves for pre-1986 accident years occurred without a change in methodology, petitioner contends that the increase does not constitute "reserve strengthening".

Petitioner further argues that there is no need to consider the legislative history to interpret the term "reserve strengthening", because the term is unambiguous. Accordingly, petitioner argues that the regulatory definition of "reserve strengthening" is invalid to the extent that it treats all net additions in 1986, to pre-1986 loss reserves, as "reserve strengthening".

VI. *Analysis and Conclusion*

Despite respondent's cogent arguments to the contrary, we hold that petitioner's reserve increases do not constitute "reserve strengthening". The facts of *Western National* are indistinguishable from the present case. Therefore, the doctrine of stare decisis leads us to the same result. In each case, the taxpayer's reserves, for pre-1986 years, at yearend 1986 exceeded its reserves at yearend 1985, and that excess reflected routine adjustments made consistent with past reserving practices. In each case, the

taxpayer did not change its reserving assumptions or methodology.

Respondent attempts to distinguish the present case from *Western National* based on the submission of expert testimony. In *Western National*, respondent chose not to submit expert testimony and instead contended that congressional intent, as expressed in the conference committee report, was determinative. Having lost on that argument, respondent has submitted expert testimony in the present case in her attempt to establish that the term "reserve strengthening" is subject to more than one interpretation.

The Court's decision in *Western National*, however, was not based solely on expert testimony. In fact, the Court in *Western National* acknowledged that the expert testimony submitted in that case "did not establish a universal and precise definition of reserve strengthening" but concluded that the testimony did provide "sufficient guidance to enable our recognition of the conceptual elements involved in industry jargon." *Western Natl. Mut. Ins. Co. v. Commissioner*, 102 T.C. at 351 n.10. Moreover, several of the factors cited by the Court for its decision in *Western National* did not depend on expert testimony. For example, the Court stated that: (1) Congress previously had used the term "reserve strengthening" in a life insurance industry statute in a manner consistent with the taxpayer's interpretation; (2) respondent's regulation created anomalous results; and (3) the taxpayer's interpretation of the term comported with Congress' objective of preventing willful abuse of the fresh start provision.

Respondent argues in the alternative that we should determine a lesser deficiency, because all or some of

petitioner's additions to its IBNR and LAE reserves resulted from management's discretionary adjustments. We disagree. In both *Western National* and the present case, case reserves formed the majority of petitioner's loss reserves and were not adjusted by management. Moreover, in both cases senior management retained some discretion to adjust the reserve amounts arrived at through formulaic computations, and both taxpayers maintained that the adjustments were made pursuant to actuarial data to ensure the adequacy of reserves. There were no increases to the reserves for the period in question attributable to changes in underlying assumptions or methodology.

To reflect the foregoing,

Decision will be entered for petitioners.

TAX REFORM ACT OF 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2404, 99th Cong., 2d Sess. §1023(e) (1986).

Sec. 1023. DISCOUNTING OF UNPAID LOSSES AND CERTAIN UNPAID EXPENSES.

* * * * *

(e) EFFECTIVE DATE.--

* * * * *

(2) TRANSITIONAL RULE.- For the first taxable year beginning after December 31, 1986-

(A) the unpaid losses and the expenses unpaid (as defined in paragraphs (5)(B) and (6) of section 832 (b) of the Internal Revenue Code of 1986) at the end of the preceding taxable year, and

(B) the unpaid losses as defined in sections 807(c)(2) and 805(a)(l) of such Code at the end of the preceding taxable year,

shall be determined as if the amendments made by this — section had applied to such unpaid losses and expenses unpaid in the preceding taxable year and by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 1987. For subsequent taxable years, such amendments shall be applied with respect to such unpaid losses and expenses unpaid by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 1987.

(3) FRESH START.-

(A) IN GENERAL.-Except as otherwise provided in this paragraph, any difference between

(i) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2), and

(ii) such amount determined with regard to paragraph (2),

shall not be taken into account for purposes of the Internal Revenue Code of 1986.

(B) RESERVE STRENGTHENING IN YEARS AFTER 1985.-Subparagraph (A) shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

DEFICIT REDUCTION ACT OF 1984, Pub. L. No. 98-369, 98 Stat. 494, 758, 98th Cong., 2d Sess., § 216.

Sec. 216. RESERVES COMPUTED ON NEW BASIS; FRESH START.

(a) RECOMPUTATION OF RESERVES.-

(1) IN GENERAL.--As of the beginning of the first taxable year beginning after December 31, 1983, for purposes of subchapter L of the Internal Revenue Code of 1954 (other than section 816 thereof), the reserve for any contract shall be recomputed as if the amendments made by this subtitle had applied to such contract when it was issued.

* * * * *

(b) FRESH START.--

(1) IN GENERAL.--Except as provided in paragraph (2), in the case of any insurance company, any change in the method of accounting (and any change in the method of computing reserves) between such company's first taxable year beginning after December 31, 1983, and the preceding taxable year which is required solely by the amendments made by this subtitle shall be treated as not being a change in the method of accounting (or change in the method of computing reserves) for purposes of the Internal Revenue Code of 1954.

* * * * *

(3) REINSURANCE TRANSACTIONS, AND RESERVE STRENGTHENING, AFTER SEPTEMBER 27, 1983.

(A) IN GENERAL.--Paragraph (1) shall not apply (and section 807 (f) of the Internal Revenue Code of 1954 as amended by this subtitle shall apply--)

(i) to any reserve transferred pursuant to--

(I) a reinsurance agreement entered into after September 27, 1983, and before January 1, 1984, or

(II) a modification of a reinsurance agreement made after September 27, 1983, and before January 1, 1984, and

(ii) to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984.

Clause (ii) shall not apply to the computation of reserves on any contract issued if such computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which such reserves are set up.

TREASURY REGULATIONS ON INCOME TAX (26 C.F.R.):

§1.846-3(c) Rules for determining the amount of reserve strengthening (weakening)--(l) In general. The amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in 1986. For purposes of section 1023(e)(3)(B) of the 1986 Act, the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. The amount of reserve strengthening for an unpaid loss reserve may not exceed the amount of the reserve, including any undiscounted strengthening amount, as of the end of the last taxable year beginning before January 1, 1987. For purposes of this section, an "unpaid loss reserve" is the aggregate of the unpaid loss estimates for losses (whether or not reported) incurred in an accident year or line of business.

(2) Accident years after 1985--(i) In general. The amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year after 1985 is the amount by which that reserve at the end of the last taxable year beginning in 1986 exceeds (is less than) a hypothetical unpaid loss reserve.

(ii) Hypothetical unpaid loss reserve. For purposes of this paragraph (c)(2), the term "hypothetical unpaid loss reserve" means a reserve computed for losses the estimates of which were included, at the end of the last taxable year beginning in 1986, in the unpaid loss reserve for which reserve strengthening (weakening) is being determined. The hypothetical unpaid loss reserve must be computed using the same assumptions, other than the assumed interest rates in the case of reserves determined on a discounted basis for annual statement reporting purposes, that were used to determine the 1985 accident year reserve, if any, for the line of business for which the hypothetical reserve is being computed. If there was no 1985 accident year reserve for that line of business, the hypothetical unpaid loss reserve is the reserve, at the end of the last taxable year beginning in 1986, for which reserve strengthening (weakening) is being determined (and thus there is no reserve strengthening or weakening).

(3) Accident years before 1986--(i) In general. For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of the taxable year exceeds (is less than)--

(A) The reserve at the end of the immediately preceding taxable year; reduced by

(B) Claims paid and loss adjustment expenses paid ("loss payments") in the taxable year beginning in 1986 with respect to losses that are attributable to

the reserve. The amount by which a reserve is reduced as a result of reinsurance ceded during a taxable year beginning in 1986 is treated as a loss payment made in the taxable year.

(ii) Exceptions. Notwithstanding paragraph (c) (3) (i) of this section, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 does not include--

(A) An amount added to the reserve in a taxable year beginning in 1986 as a result of a loss reported to the taxpayer from a mandatory state or federal assigned risk pool if the amount of the loss reported is not discretionary with the taxpayer; or

(B) Payments made with respect to reinsurance assumed during a taxable year beginning in 1986 or amounts added to the reserve to take into account reinsurance assumed for a line of business during a taxable year beginning in 1986, but only to the extent that the amount does not exceed the amount of a hypothetical reserve for the reinsurance assumed. The amount of the hypothetical reserve is determined using the same assumptions (other than the assumed interest rates) that were used to determine a reserve for reinsurance assumed for the line of business in a taxable year beginning in 1985.

(2)

Supreme Court, U.S.
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No. 97-147

In the Supreme Court of the United States

OCTOBER TERM, 1996

ATLANTIC MUTUAL INSURANCE CO. AND INCLUDIBLE SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether 26 C.F.R. 1.846-3(c) correctly interprets the term "reserve strengthening" as used in Section 1023(e)(3)(B) of the Tax Reform Act of 1986.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A25) is reported at 111 F.3d 1056. The opinion of the Tax Court (Pet. App. A26-A47) is unofficially reported at 71 T.C.M. (CCH) 2154.

JURISDICTION

The judgment of the court of appeals was entered on April 24, 1997. The petition for a writ of certiorari was filed on July 21, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a property and casualty insurance company (Pet. App. A6). Such companies maintain an accounting reserve for their "unpaid losses." The reserve for unpaid losses consists of amounts that each insurer estimates it will ultimately be required to pay (i) on losses already reported ("case reserves"), (ii) on losses not yet reported but estimated to have occurred ("incurred but not reported" loss reserves) and (iii) in connection with the determination and adjustment of such losses ("loss adjustment expense" reserves) (*id.* at A6 n.4).

During the 1986 taxable year, petitioner made net additions to the reserves it maintained for accidents that occurred prior to that year. Those increases in reserves were not attributable to any changes in the methods of estimation (Pet. App. A45). Instead, they were the result of additional experience on the loss claims and "routine adjustments" by claims adjusters (*ibid.*).

Section 1.846-3(c)(3) of the Treasury Regulations defines the term "reserve strengthening," as used in Section 1023(e)(3)(B) of the Tax Reform Act of 1986, generally to include any additions made to net reserves, even if stemming from routine adjustments. The Commissioner of Internal Revenue therefore determined that the increases to petitioner's reserves for losses occuring prior to 1986 constituted "reserve strengthening" under Section 1023(e)(3)(B) of the Tax Reform Act of 1986 (Pet. App. A7). Based on that determination, petitioner was required to recognize additional taxable income of $1,339,039 for 1987, with a resulting deficiency in tax of $519,987 for that year (*ibid.*).

2. Petitioner commenced this action in Tax Court to contest the deficiency determination of the Commissioner (Pet. App. A7).

a. The issue addressed in this case is whether Section 1.846-3(c) of the Treasury Regulations (26 C.F.R. 1.846-3(c)) correctly defines the term "reserve strengthening," as used in Section 1023(e)(3)(B) of the Tax Reform Act of 1986, to include changes in reserves attributable to routine claims adjustment. That question was first considered by the Tax Court in *Western National Mutual Insurance Co.* v. *Commissioner*, 102 T.C. 338 (1994), aff'd, 65 F.3d 90 (8th Cir. 1995). In that case, the taxpayer argued that the term "reserve strengthening" is understood in the insurance industry to involve only those increases to reserves that result from changes in the assumptions or methodology used to compute reserves. The taxpayer contended in that case, as here, that the term does not encompass the type of increases to unpaid loss reserves that result from routine claims processing. 102 T.C. at 346-347. The taxpayer in *Western National* introduced expert testimony that purported to establish the technical meaning of the term "reserve strengthening" in the insurance industry. The Commissioner did not offer any opposing expert testimony in that case. Instead, the Commissioner relied on the legislative history of Section 1023(e)(3)(B) to support the definition of the term "reserve strengthening" contained in the agency's interpretive regulation. 102 T.C. at 347.

In *Western National*, the Tax Court invalidated the regulation in a reviewed opinion with four judges dissenting. The majority relied on the taxpayer's expert witnesses in concluding that the term "reserve strengthening" has an "industry meaning"

that is narrower than the definition contained in the agency's regulation. 102 T.C. at 360. The court concluded that the statute incorporates the "industry usage" of the term and is therefore "neither unambiguous nor imprecise" (*id.* at 360 & n.25). Because the interpretive regulation conflicts with the "industry meaning" of the term "reserve strengthening," the court concluded that the regulation conflicts with the statute and is therefore invalid. On appeal, the Eighth Circuit affirmed. 65 F.3d 90 (1995).

b. In the present case, both the Commissioner and the taxpayer introduced expert reports at trial that addressed the meaning of "reserve strengthening" in the property and casualty insurance industry. Those expert reports, which are summarized in detail by the court below, "ma[de] clear that the term 'reserve strengthening' as used in section 1023(e)(3)(B) is subject to more than one interpretation" (Pet. App. A9 & n.5). See also *id.* at A43.

The Tax Court nonetheless again concluded that the taxpayer was not liable for the asserted deficiency (Pet. App. A27). The court stated that its prior decision "was not based solely on expert testimony" (*id.* at A46) but also on the legislative history of the provision (*id.* at A36-A38). The court acknowledged that the Conference Committee "substantially revised the 'reserve strengthening' language contained in both the Senate bill and in the accompanying Senate Finance Committee Report," which had limited reserve strengthening to changes in reserve practices (*id.* at A36). The court further noted that the Conference Committee Report "provided a more expansive definition of the term [reserve strengthening] than that contained in the Finance Committee report" (*id.* at A38). The court therefore agreed that the agency's regulation "provided a definition of 'reserve strengthening' consistent with the conference committee report" (*id.* at A41). But, in *Western National*, the court had emphasized that the Conference Committee Report *also* states that the limitation on "reserve strengthening" is designed "to prevent taxpayers from artificially increasing" reserves (*id.* at A42, quoting H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. at II-367 (1986)). The court reasoned that this reference to artificial adjustments refers "to changes in assumptions or methodology" rather than routine loss adjustments (Pet. App. A42). The court ultimately concluded that, despite the Commissioner's "cogent arguments to the contrary," principles of *stare decisis* required it to adhere to the decision in *Western National* (*id.* at A45).

3. The court of appeals reversed (Pet. App. A1-A25). The court concluded that there is no plain meaning, or consistent industry usage, of the term "reserve strengthening" as that term is used in Section 1023(e)(3)(B) of the Tax Reform Act of 1986. To the contrary, the "expert testimony here makes clear that the term 'reserve strengthening' as used in [the statute] is subject to more than one interpretation" (Pet. App. A9 & n.5). In view of the "lack of an explicit statutory definition of reserve strengthening" and "the conflicting definitions of reserve strengthening provided by the expert witnesses," the court held that "the Tax Court erred as a matter of law in holding that the meaning of reserve strengthening in section 1023(e)(3)(B) was plain" (Pet. App. A15).[1]

[1] The court of appeals also stated that the Tax Court erred in *Western National* by relying on the meaning of the term

Finding the words of the statute to be ambiguous, the court concluded that it is required by *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), "to take a deferential approach to ascertaining whether the agency's interpretation is a permissible one" (Pet. App. A15). The court emphasized that "where reasonable minds may differ * * * , courts should defer to the informed experience and judgment of the agency to whom Congress delegated appropriate authority" (*id.* at A24 n.13, quoting *Mourning* v. *Family Publications Services, Inc.*, 411 U.S. 356, 371 (1973)). The court held that the broad definition of "reserve strengthening" contained in the regulation satisfies this deferential standard because the agency's interpretation is consistent with the language of the statute, its history and its underlying purpose (Pet. App. A15-A25).

"reserve strengthening" as used in the *life* insurance industry. The court explained that the meaning of "reserve strengthening" in the life insurance industry has no direct relevance to the meaning of that term in the property and casualty insurance industry (Pet. App. 12a-13a):

> [L]ife insurance companies and P & C insurers are taxed in entirely separate manners. Gross income as well as loss reserves are computed on different bases and assumptions. Actuarial assumptions about interest rates and mortality rates are an integral part of computing future losses which form the basis of the loss reserves in life insurance. On the other hand, P & C loss reserves are determined primarily based on past claims experience and the judgments of the individual claims adjusters.

DISCUSSION

The court of appeals correctly held that the regulation establishes a permissible interpretation of Section 1023(e)(3)(B) of the Tax Reform Act of 1986. The decision in this case, however, conflicts with the decision of the Eighth Circuit in *Western National Mutual Insurance Co.* v. *Commissioner*, 65 F.3d 90 (8th Cir. 1995). The issue addressed in these conflicting decisions affects the 1987 tax liability of a significant portion of the property and casualty insurance industry, with consequences for taxable income in excess of $1 billion. Although it is possible that this conflict could be reconciled in future litigation, we do not oppose the granting of certiorari in this case.

1. Section 832(c)(4) of the Internal Revenue Code authorizes a deduction for "losses incurred" in computing the taxable income of a property and casualty insurance company. 26 U.S.C. 832(c)(4). Prior to 1986, the term "losses incurred" was defined by Section 832(b)(5) of the Code to mean the amount of "losses paid" during the year plus the increase (or minus the decrease) in "unpaid losses." 26 U.S.C. 832(b)(5) (1982).[2] That pre-1986 provision gave an unwarranted benefit to property and casualty companies, for it failed to take the time value of money into account in determining the permissible deduction.

[2] A property and casualty company was permitted to deduct the full amount of the estimated loss in the year the loss occurred, even though the claim might not be paid for several years. When the claim was paid, the company would not receive any additional deduction (assuming that the payment equalled the original loss estimate) because the payment would be offset by a corresponding reduction in its unpaid loss reserve.

See S. Rep. No. 313, 99th Cong., 2d Sess. 499-500 (1986); note 2, *supra*.

Congress attempted to solve this problem by adding Section 846 to the Code as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023(c), 100 Stat. 2399. That Section requires unpaid losses to be discounted to present value when claimed as a deduction. 26 U.S.C. 846. As part of the same legislation, Congress amended Section 832(b)(5)(A) to reflect the new discounting requirements. Under that new Section, the deduction for "losses incurred" is computed by adding to losses paid "all discounted unpaid losses (as defined in section 846) outstanding at the end of the taxable year" and deducting therefrom "all discounted unpaid losses outstanding at the end of the preceding taxable year." 26 U.S.C. 832(b)(5)(A).

Congress enacted a series of transitional rules to implement these new accounting procedures. Section 1023(e)(1) of the Tax Reform Act of 1986 specifies that the new discounting rules "shall apply to taxable years beginning after December 31, 1986." 100 Stat. 2404. As the Tax Court noted (Pet. App. 34a), if no exception had been made to this new requirement, property and casualty companies would have been required to compare "old law" (undiscounted) year-end 1986 reserves with "new law" (discounted) year-end 1987 reserves, thus causing a one-time reduction of the losses incurred deduction in 1987. To avoid that sharp consequence, Congress established a transitional rule—Section 1023(e)(2) of the Tax Reform Act of 1986—which specifies that, in computing the 1987 deduction for losses incurred, the year-end 1986 reserves are also to be discounted to present value.

Without any further transitional provision, this special rule would have required property and casualty companies to take into income in 1987 the excess of their undiscounted year-end 1986 reserves over their discounted year-end 1986 reserves. This is because (i) the new requirement of discounting constitutes a change of accounting method, (ii) that new accounting method yields a double deduction for property and casualty companies[3] and (iii) Section 481(a) of the Code requires an appropriate adjustment to prevent the taxpayer from obtaining a double deduction created by a change in accounting method.[4]

[3] The double deduction may be illustrated as follows:

No discounting. Assume that an automobile accident occurs in Year 1, and the insurance company estimates it will eventually pay a total of $10 in claims stemming from that accident. Assume further that the $10 is in fact paid out in Year 5.

The tax treatment is as follows: In Year 1, the company adds $10 to its "unpaid losses," and obtains a deduction of $10. In Year 5, when the company makes the payment, it increases its "losses paid" by $10, but reduces its "unpaid losses" by $10. This is a wash.

With discounting. Assume the same facts as above. Assume, in addition, that discounting goes into effect in Year 4, and the company's "unpaid losses" account is reduced in that year, tax-free, to $9.

The tax treatment is as follows: The company again gets a Year 1 deduction of $10. In Year 5, however, when the company makes the payment, it increases its "losses paid" by $10, but reduces its "unpaid losses" by only $9, and thus gets a net additional deduction of $1. The company thus gets a total deduction (in Year 1 and Year 5) of $11 for a $10 payment.

[4] Under Section 481(a) of the Code, if the taxpayer's taxable income is computed "under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed," then

Congress decided to permit taxpayers to obtain a limited double deduction in this particular situation, however, by enacting a "fresh start" provision in Section 1023(e)(3)(A) of the Tax Reform Act of 1986. Section 1023(e)(3)(A) provides (100 Stat. 2404):

(3) FRESH START.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, any difference between—

(i) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2) [*i.e.*, without discounting], and

(ii) such amount determined with regard to paragraph (2) [*i.e.*, with discounting],

shall not be taken into account for purposes of the Internal Revenue Code of 1986.

The double deduction provided by the "fresh start" provision gave property and casualty companies an incentive to increase their unpaid-loss reserves during the 1986 taxable year. Congress addressed that problem by enacting Section 1023(e)(3)(B) of the Tax Reform Act of 1986, which precludes application of the "fresh start" provision—and thus permits the normal application of Section 481(a)—with respect to any

"there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted * * *." 26 U.S.C. 481(a).

"reserve strengthening" that occurred in 1986. Section 1023(e)(3)(B) provides (100 Stat. 2404):[5]

(B) RESERVE STRENGTHENING IN YEARS AFTER 1985.—Subparagraph (A) [the fresh start provision] shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

[5] The enacted version of this "reserve strengthening" provision differs from the version contained in the bill approved by the Senate Finance Committee. That bill had explicitly linked reserve strengthening to a change in the insurer's reserve practice. It provided (H.R. 3838, 99th Cong., 2d Sess., § 1022(e)(3)(B) (1986), as reported by the Senate Finance Committee, May 29, 1986):

(B) *Reserve Strengthening After March 1, 1986.* * * * [The fresh start adjustment] shall not apply to any reserve strengthening reported for Federal income tax purposes after March 1, 1986, for a taxable year beginning before January 1, 1987, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986. The preceding sentence shall not apply to the computation of reserves on any contract if such computation employs the reserve practice used for purposes of the most recent annual statement filed on or before March 1, 1986, for the type of contract with respect to which reserves are set up.

See 132 Cong. Rec. 16,130-16,131 (1986).

The Conference Committee Report explains the application of this provision (H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. at II-367 (1986)) (emphasis added):

Fresh start adjustment

The conference agreement follows the Senate amendment with respect to providing a fresh start adjustment—i.e., a forgiveness of income—for the reduction in reserves resulting from discounting the opening reserves in the first post-effective date taxable year of the provision. The conference agreement modifies the Senate amendment with respect to the treatment of reserve strengthening under the fresh start income forgiveness provision. Under the conference agreement, reserve strengthening in taxable years beginning after December 31, 1985, is not treated as a reserve amount for purposes of determining the amount of the fresh start. Instead, such reserve strengthening additions to loss reserves in taxable years beginning in 1986 are treated as changes to reserves in taxable years beginning in 1987, and are subject to discounting. *Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year)*, and all additions to reserves resulting from a change in the assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves.

This provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision.

In 1992, the Treasury promulgated a regulation to interpret and implement this transitional rule. Section 1.846-3 of the Treasury Regulations, 26 C.F.R. 1.846-3, provides (emphasis added):

(c) *Rules for determining the amount of reserve strengthening (weakening)*—(1) *In general.* The amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in 1986. For purposes of section 1023(e)(3)(B) of the 1986 Act, the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. * * *

* * * * *

(3) *Accident years before 1986.*—(i) *In general.* For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of the taxable year [*i.e.*, 1986] exceeds (is less than)—

(A) The reserve at the end of the immediately preceding taxable year [*i.e.*, 1985]; reduced by

(B) Claims paid and loss adjustment expenses paid ("loss payments") in the taxable year beginning in 1986 with respect to losses that are attributable to the reserve. * * * [6]

2. The court of appeals correctly held that the definition of "reserve strengthening" under the regulation does not conflict with the "plain meaning" of the statute. As the Eighth Circuit acknowledged in *Western National*, the meaning of the term "reserve strengthening" is not apparent from the face of the statute. See 65 F.3d at 92. And, in the present case, unlike in *Western National*, the conflicting expert testimony made it clear that there is no consistent industry usage and that "the term 'reserve strengthening' as used in section 1023(e)(3)(B) is subject to more than one interpretation" (Pet. App. A9; see also *id.* at A43).[7]

[6] The regulation provides two exceptions from this rule: (i) an amount added to a reserve in 1986 as a result of a loss reported to the taxpayer from a mandatory state or federal assigned risk pool if the amount of the loss reported is not discretionary with the taxpayer; (ii) payments made with respect to reinsurance assumed during 1986 or amounts added to the reserve to take into account reinsurance assumed for a line of business during 1986, but only to the extent the amount does not exceed the amount of a hypothetical reserve for the reinsurance assumed. 26 C.F.R. 1.846-3(c)(3)(ii). Neither exception applies in this case.

[7] In *Massachusetts* v. *Blackstone Valley Electric Co.*, 67 F.3d 981, 986-987 (1st Cir. 1995), the court concluded that a statutory term is ambiguous when conflicting expert explanations reveal an inconsistent usage. See also *National Railroad Passenger Corp.* v. *Boston & Maine Corp.*, 503 U.S. 407, 418

The court of appeals correctly concluded in this case that the regulation draws substantial support from the legislative history of the statute. The Conference Report, which is entitled to great weight in interpreting the statute (*National Ass'n of Greeting Card Publishers* v. *United States Postal Service*, 462 U.S. 810, 832 n.28 (1983)), expressly states, as the regulation provides, that the term "[r]eserve strengthening is considered to include *all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year*" (Pet. App. A17, quoting H.R. Conf. Rep. No. 841, *supra*, at II-367 (emphasis added)). The court of appeals correctly noted that the Senate amendment, which had explicitly linked the "reserve strengthening" provision to changes in reserve methodologies (see note 5, *supra*), had been deleted by the Conference Committee and that the Conference Committee Report contains a far more expansive definition of the term "reserve strengthening" than the Senate Finance Committee had provided (Pet. App. A15-A19). The court correctly concluded that the definition of "reserve strengthening" set forth in the regulation must be sustained because it is consistent with the text and history of the statute and advances its purpose of preventing abuses of the "fresh start" provision (*id.* at A22-A23).

3. Petitioner contends (Pet. 12-15) that the definition of "reserve strengthening" set forth in the regulation is inconsistent with the use of that same term in the provisions applicable to *life* insurance reserves

(1992) ("The existence of alternative dictionary definitions of the word 'required,' each making some sense under the statute, itself indicates that the statute is open to interpretation.").

enacted in Section 216(b)(3) of the Tax Reform Act of 1984, Pub. L. No. 98-369, Div. A, 98 Stat. 759.[8] In that provision, enacted two years before the statute involved in this case, Congress provided a fresh start adjustment for life insurance reserves and, in making that adjustment inapplicable to "any reserve strengthening" after 1984, specified that the "reserve strengthening" limitation "shall not apply * * * if [the reserve] computation employs the reserve practice used * * * before * * * for the type of [insurance] with respect to which such reserves are set up." *Ibid.*

As the court of appeals correctly concluded (Pet. App. 14a-15a), the specific exception from the "reserve strengthening" provision applicable to life insurance reserve computations supports the interpretation of that term (as used in Section 1023(e)(3)(B)) contained

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[8] The 1984 legislation provided (emphasis added):

(3) REINSURANCE TRANSACTIONS, AND RESERVE STRENGTHENING, AFTER SEPTEMBER 27, 1983.—

(A) IN GENERAL.—Paragraph (1) [*i.e.*, the fresh start adjustment] shall not apply * * *

* * * * *

(ii) to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984.

Clause (ii) shall not apply to the computation of reserves on any contract issued if such computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which such reserves are set up.

in Section 1.846-3(c)(3) of the Treasury Regulations.[9] In enacting the life insurance provisions, Congress *excluded* ordinary increases in reserves from the operation of the "reserve strengthening" clause. A similar exclusion was contained in the Senate version of Section 1023(e)(3)(B), which was deleted by the Conference Committee. As the court of appeals correctly observed (Pet. App. 14a), the deletion of this exclusion of ordinary reserve increases from the operation of the "reserve strengthening" clause reflects, as the express language of the Conference Report indicates, that Congress did *not* intend to restrict the "reserve strengthening" provision in Section 1023(e)(3)(B) to changes in reserve practices. "Where Congress includes limiting language in an earlier version of a bill but deletes it prior to enactment, it may be presumed that the limitation was not intended." *Russello* v. *United States*, 464 U.S. 16, 23-24 (1983).[10]

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[9] The court of appeals also correctly distinguished the definition of "reserve strengthening" used in the life insurance industry from the definition of "reserve strengthening" for the property and casualty industry (Pet. App. 12a-14a). As the court explained (*ibid.*), there are fundamental differences between the reserve-setting process in the life insurance industry (which is predicated upon external factors such as mortality tables and interest rates) and the reserve-setting process in the property and casualty industry (which looks to past claims experience and also involves a fact-specific determination by the individual claims adjuster based upon his or her judgment and experience).

[10] The Conference Committee Report emphasize that "[t]he conference agreement modifies the Senate amendment with respect to the treatment of reserve strengthening" and provides a more expansive definition of the term (for pre-1986 accident years) than the Senate Finance Committee had

Petitioner thus errs in relying on the untenable proposition that courts should adopt the very version of Section 1023(e)(3)(B) that had been proposed by the Senate but rejected by the Conference. As this Court has emphasized, courts have a "duty to refrain from reading a phrase into the statute when Congress has left it out." *Keene Corp.* v. *United States*, 508 U.S. 200, 208 (1993).[11]

4. Although the decision of the court of appeals in the present case is correct, we agree with petitioner that the decision in this case conflicts with the

provided. H.R. Conf. Rep. No. 841, *supra*, at II-367. The intent of the Conference Committee to expand the definition of "reserve strengthening" was so clear that it provoked criticism from Senator Wallop, an opponent of that action (Pet. App. 18a).

[11] Petitioner errs in asserting (Pet. 11) that *Rowan Cos.* v. *United States*, 452 U.S. 247 (1981), supports the conclusion that Congress incorporated the life insurance provisions relating to reserve strengthening in enacting Section 1023(e)(3)(B). In *Rowan*, the Court invalidated a Treasury regulation that gave the term "wages" a different interpretation for purposes of federal employment taxes than the same term had for purposes of income tax withholding. The Court emphasized that (i) the respective statutes contain virtually identical definitions of the term and (ii) the legislative history accompanying the income tax witholding statute indicated that the term was to be construed consistently with the federal employment tax statutes. 452 U.S. at 255-257. Section 1023(e)(3)(B), however, does not contain a definition of "reserve strengthening." The language of Section 1023(e)(3)(B) also differs materially from the language of the life insurance "reserve strengthening" provision. And, as the Third Circuit correctly recognized (Pet. App. 15a-23a), the legislative history of Section 1023(e)(3)(B) conclusively demonstrates that Congress did not intend to restrict the definition of "reserve strengthening" to reserve increases resulting from changes in reserve practices.

decision of the Eighth Circuit in *Western National Mutual Insurance Co.* v. *Commissioner*, *supra*. In *Western National*, the court of appeals adopted the Tax Court's factual "determination that reserve strengthening has a settled meaning in the property and casualty industry" and that, in industry usage, "reserve strenghtening occurs 'when a method or assumption used in calculating policy reserves is changed so as to produce higher reserves.'" 65 F.3d at 93, quoting *Western National Mutual Insurance Co.* v. *Commissioner*, 102 T.C. 338, 351 (1994). The court concluded in *Western National* "that reserve strenghtening is an example of congressional employment of industry language" and, in view of the "settled meaning" of the term in the insurance industry, "reserve strengthening is not an ambiguous term." 65 F.3d at 92, 93. The court reasoned in *Western National* that the agency's interpretive regulation is invalid because "it adopts a definition of reserve strengthening that is at variance with industry usage." *Id.* at 93.

The Third Circuit correctly observed that the record of the present case (Pet. App. 9a) differs from the record involved in *Western National*. In *Western National*, the Commissioner did not contest the expert testimony that the taxpayer introduced—and on which the court relied—to establish that reserve strengthening "has a settled meaning in the property and casualty industry" (65 F.3d at 93). In the present case, by contrast, the Commissioner introduced expert testimony that established that the term "reserve strengthening" lacks any precise industry usage and "is subject to more than one interpretation" (Pet. App. A9 & n.5). See also *id.* at A43.

Whether, on this different and more complete factual record, the Eighth Circuit would reach a different conclusion on the question presented in this case is, of course, impossible to determine in advance with certainty. It is possible that proof of the type submitted in this case—establishing that the term "reserve strengthening" lacks a definite usage in the property and casualty industry—would lead that court to reconsider its prior holding.[12] It is certain, however, that further litigation of this issue would be required, in both the Eighth Circuit and other circuits as well, in an attempt to bring about a uniform resolution of this question.

Although the issue presented in this case involves a transitional rule that affects the calculation of taxes for the property and casualty industry only for the 1987 tax year, we are advised by the Internal Revenue Service that the identical issue is presented in numerous pending cases, with estimated total adjustments exceeding $1 billion. The inconsistent results that have been reached thus may have substantial disparate effects on companies that compete with one another. Review by this Court of this substantial

[12] The court of appeals noted in the present case that, although the Eighth Circuit had based its decision in *Western National* on its understanding of industry usage, that court had "nonetheless proceeded to examine the legislative history * * * and determined that it failed to provide persuasive rationale for intepreting 'reserve strengthening' contrary to industry usage" (Pet. App. A12 n.7). By contrast, on the different record of this case, the Third Circuit found no persuasive evidence of any consistent industry usage and concluded that the legislative history persuasively explained that the agency had correctly interpreted the ambiguity inherent in the text of the provision (*id.* at A9-A25).

recurring question, on which the courts of appeals have reached inconsistent conclusions, would be appropriate.

CONCLUSION

The petition for a writ of certiorari should be granted.[13]

Respectfully submitted.

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Attorneys

SEPTEMBER 1997

[13] In light of the support for the Commissioner's position reflected in the legislative history we have recounted and the deference owing to the interpretation set forth in the pertinent Treasury Regulation (see, *e.g.*, *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 488 (1979)), the Court may wish to consider summary affirmance.

Supreme Court, U.S.
FILED
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No. 97-147

In the
Supreme Court of the United States
October Term, 1997

ATLANTIC MUTUAL INSURANCE CO. and
Includible Subsidiaries,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Third Circuit

REPLY BRIEF OF PETITIONER

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6 pp

No. 97-147

In the
SUPREME COURT OF THE UNITED STATES

October Term, 1997

ATLANTIC MUTUAL INSURANCE CO. and
Includible Subsidiaries,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE THIRD CIRCUIT.

REPLY BRIEF OF PETITIONER

Respondent's brief ("Res. Br.") concludes that the Petition for Writ of Certiorari herein should be granted. Nevertheless, respondent adds that in view of the arguments contained in his brief, the Court may wish to consider summary affirmance. (Res. Br. at 21, n. 13.) Petitioner

submits that summary affirmance is patently inappropriate in this case.

DISCUSSION

The decision of the Court of Appeals for the Third Circuit in this case directly conflicts with the decision of the United States Tax Court below and the decisions of the Court of Appeals for the Eighth Circuit and the Tax Court in *Western National Mutual Insurance Co. v. Commissioner*, 65 F. 3d 90 (8th Cir. 1995), *aff'g*, 102 T.C. 338 (1994). The Eighth Circuit and the Tax Court each held that section 1.846-3(c)(3) of the Treasury regulations conflicts with the plain meaning of the statute and therefore is invalid. The Tax Court specifically found that the facts here are indistinguishable from those in *Western National*. (Pet. App. A45.)

While agreeing with petitioner that the Third Circuit's decision in this case conflicts with the Eighth Circuit's decision in *Western National* (Res. Br. at 14), respondent seemingly attempts to distinguish *Western National* (Res. Br. at 20) in order to present this case as one for summary affirmance. In this connection, respondent points out that he did not contest the expert testimony that taxpayer introduced in *Western National*, and respondent implies that the Eighth Circuit would have reached a different decision if it had been presented with the record of this case. *Id.* Although there was some differing expert testimony in *Western National* and this case, the Eighth Circuit specifically stated that it would have reached the same decision in *Western National* without regard to expert testimony. 65 F.3d at 93. Moreover, the Tax Court did in fact reach the same decision in this case as it did in

Western National notwithstanding the expert testimony respondent presented in this case. *Atlantic Mutual Insurance Co. v. Commissioner*, 71 T.C.M. (CCH) 2154 (1996), *rev'd*, 111 F.3d 1056 (3d Cir. 1997).

The decisions of the Eighth Circuit and the Tax Court are recent and thoroughly reasoned. The conflict in the approaches used by the Eighth Circuit and the Tax Court on the one hand and the Third Circuit on the other hand plainly deserves more than the summary attention of this Court.

Separately, respondent incorrectly maintains that the Conference Committee's deletion of an ambiguous sentence from the Senate Finance bill clearly signals Congress' intention to redefine the term reserve strengthening as used in the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2404 (the "Act"), to mean any reserve increase, rather than only those reserve increases caused by changes in assumptions or methodologies consistent with longstanding industry usage. (Res. Br. at 15.) Respondent states:

> In enacting the life insurance provisions, Congress *excluded* ordinary increases in reserves from the operation of the "reserve strengthening" clause. A similar exclusion was contained in the Senate version of Section 1023(e)(3)(B), which was deleted by the Conference Committee. (Res. Br. at 17.)

In fact, what the Conference Committee deleted from the Senate version of section 1023 of the Act was a single sentence that was patterned on a sentence in section 216 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98

Stat. 494,758 ("DEFRA"). As used in DEFRA, the sentence in question pertained *only* to insurance contracts issued in 1983 (and not to the overall reserves held by the insurance company for contracts issued in prior years). The sentence in DEFRA had *no* impact on the *general* definition of reserve strengthening for purposes of that statute. Indeed, that sentence did not even appear in the original version of the reserve strengthening provisions of DEFRA contained in the House Ways and Means bill, yet there was never any question that under the House bill ordinary increases in reserves were excluded from the meaning of reserve strengthening.

As can be seen from even a brief account of the drafting history of section 216 of DEFRA and section 1023 of the Act, respondent's one-sided analysis of the legislative history is misleading. It would be wrong to conclude summarily that Congress intended to give the term reserve strengthening a meaning different from the DEFRA meaning based on the omission from the Act of a single sentence contained in DEFRA that was intended to provide a special rule applicable only to reserves on newly issued insurance contracts during the year the legislation was enacted.

CONCLUSION

The petition for a writ of certiorari should be granted and respondent's suggestion that the Court may wish to consider summary affirmance should be rejected.

Dated: October 1, 1997

Respectfully submitted,

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Supreme Court, U.S.
FILED
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In the
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ATLANTIC MUTUAL INSURANCE CO. AND
INCLUDIBLE SUBSIDIARIES,
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v.
COMMISSIONER OF INTERNAL REVENUE,
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On Writ of Certiorari
To The United States Court of Appeals
For The Third Circuit

JOINT APPENDIX

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Petition for Certiorari Filed July 22, 1997
Certiorari Granted October 20, 1997

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UNITED STATES TAX COURT
DOCKET ENTRIES

0001	12/06/93	PETITION Filed:Fee Paid
0002	12/06/93	DESIGNATION of Trial at New York, NY
0003	01/31/94	DESIGNATION of Trial at New York, NY (Newark)
0004	01/31/94	ANSWER
0005	05/23/94	JT. MOTION for assignment of case.
0006	06/06/94	ORDER that case is assigned to Judge Chiechi. Mot to assign case is gr.
0007	06/14/94	ORDER by 6/27/94 a joint proposed trial preparation schedule be filed.
0008	06/28/94	PROPOSED PRE-TRIAL SCHEDULING ORDER by Resp. (per Judge)
0009	07/07/94	ORDER set 3/13/95 New York, NY (Spec) for trial. All discovery to be completed by 12/1/94. All mots to compel discovery & mots with respect to pleadings shall be served & filed by 12/8/94. All mots to compel

		stips. are to be served & filed by 12/28/94. Stip. of Facts due 1/9/95. All mots to compel stip. of facts be served & filed by 12/28/94. Mots with respect to conduct of trial be served & filed by 1/20/95. Suppl. Stip. of Facts & Dispositive mots due by 2/10/95. Jt. status reports due 10/24/94, 12/1/94, 1/16/95 & 2/15/95.
0010	10/17/94	MOTION by Peter K. Lathrop to withdraw. (N.Obj.)
0011	10/28/94	REPORT (JOINT). (p.m.t.)
0012	11/08/94	ENTRY OF APPEARANCE by James H. Kenworthy.
0013	11/18/94	REPORT by Petr.
0014	11/18/94	REPORT by Resp.
0015	12/05/94	REPORT by the Parties (Per Judge)
0016	12/09/94	ORDER time for submitting expert witness reports is ext. to 12/16/95. Time for submitting rebuttal expert witness reports is ext. to 1/17/95.
0017	01/09/95	STIPULATION OF FACTS w/Exs. Lodged.
0018	01/18/95	REPORT (JOINT) (p.m.t.)

0019	01/25/95	MOTION by resp. in limine. (p.m.t.)
0020	01/26/95	ORDER Petrs. file to be received by 2/13/95 a response to Resp's mot. in limine.
0021	02/06/95	RESPONSE IN OPPOSITION by Petr. to Resp. mot. in limine.
0022	02/13/95	SUPPLEMENTAL STIPULATION OF FACTS w/Ex. (p.m.t.) LODGED (Per Judge)
0023	02/14/95	REPORT (JOINT) filed.
0024	02/27/95	MOTION by resp. to withdraw mot in limine. (N.Obj.)
0025	02/27/95	JT. MOTION to file Stip. of Facts. (2nd Suppl. Stip. of Facts Ld)
0026	02/27/95	ORDER trial is continued.
0027	02/28/95	STIPULATION OF FACTS filed.
0028	02/28/95	SUPPLEMENTAL STIPULATION OF FACTS
0029	02/28/95	2ND SUPPLEMENTAL STIPULATION OF FACTS
0030	03/03/95	JT. MOTION to submit case under Rule 122.

0031	03/03/95	JT. MOTION to designate 4-24-95 for Original Briefs & 5-26-95 for Reply Briefs.
0032	03/03/95	ORDER that case is submitted to Judge Chiechi. Jt. mots. to submit under Rule 122 & designate Briefing schedule are Granted. Briefs Due 5-17-95 & Answering Brfs. Due 7-3-95.
0033	05/11/95	ORDER that case is submitted to Judge Foley. No longer submitted to Judge Chiechi.
0034	05/16/95	MOTION by resp. to ext. time to 5/19/95 & 7/5/95 for briefs. (N. Obj.)
0035	05/19/95	BRIEF for petr.
0036	05/22/95	BRIEF for resp. (Leave Gr.)
0037	07/05/95	REPLY BRIEF for resp.
0038	07/06/95	REPLY BRIEF for petr. (p.m.t.)
0039	10/26/95	MOTION by resp. to file supplemental brief (Suppl. Brf. Ld.).
0040	11/01/95	ORDER mot. to file suppl. brf. is Cr. Petr. by 11/24/95 file reply to suppl. brf.
0041	11/01/95	SUPPLEMENTAL BRIEF by resp.

0042	11/09/95	MOTION by petr. to ext. time to 12/1/95 to file Reply to Supplemental Brief. (N.Obj.)
0043	12/01/95	REPLY by petr. to supplemental brief.
0044	02/22/96	MEMORANDUM OPINION, Judge Foley T.C. Memo. 1996-75 (Decision will be entered for Petr.)
0045	03/11/96	NOTICE of Change of Address for atty. John S. Breckinridge, Jr.
0046	03/11/96	NOTICE of Change of Address for atty. James H. Kenworthy.
0047	04/01/96	STIPULATION for entry of decision. (File Per Judge)
0048	04/23/96	DECISION ENTERED, Judge Foley

APPELLATE PROCEEDINGS

0049	06/26/96	NOTICE OF APPEAL by resp. to U.S.C.A., 3rd Cir.
0050	06/27/96	NOTICE of Filing with copy of notice of appeal mailed to John S. Breckinridge, Jr.
0051	06/27/96	NOTICE Regarding Record.

GENERAL DOCKET FOR
Third Circuit Court of Appeals

7/10/96	Tax Court Case Docketed. Notice filed by Commissioner IRS. (pat)
7/22/96	APPEARANCE from Attorneys John S. Breckinridge, Frederick B. Lacey & James H. Kenworthy on behalf of Appellee Atl Mutl Ins Co, filed. (mmb)
7/22/96	DISCLOSURE STATEMENT on behalf of Appellee Atl Mutl Ins Co, filed. (mmb)
7/22/96	APPEARANCE from Attorneys Gary R. Allen, Edward T. Perelmuter & David I. Pincus on behalf of Appellant Commissioner IRS, filed. (mmb)
7/22/96	INFORMATION STATEMENT on behalf of Appellant Commissioner IRS, RECEIVED. (mmb)
7/22/96	STATEMENT OF FACTS AND ISSUES on behalf of Appellant Commissioner IRS, received. (mmb)
8/2/96	BRIEFING NOTICE ISSUED. Petitioner brief and appendix due 9/11/96, filed. (pat)

9/11/96	APPENDIX on behalf of Appellant Commissioner IRS Copies: 4 Volumes: 1, Delivered by mail, filed. Certificate of service date 9/11/96. (par)
9/16/96	MOTION filed by Appellant, Commissioner IRS, to file corrected brief. Answer due 9/23/96. Certificate of Service dated 9/12/96. (cpm)
10/9/96	ORDER (Clerk) granting motion by appellant, Commissioner IRS to file corrected brief. The brief is filed as of the date of this order. The Brief previously filed on September 11, 1996 is stricken. Counsel is directed to retrieve the previously filed brief within 10 days from the date of this order or such shall be destroyed, filed. (cpm)
10/9/96	CORRECTED APET BRIEF on behalf of Commissioner of Internal Revenue, Pages: 50, Copies: 10, Delivery by mail, filed. (bmh)
10/11/96	BRIEF on behalf of Appellee Atl Mutl Ins Co, Pages: 50, Copies: 10, Delivered by mail, filed. Certificate of Service date 10/11/96. (bmh)

10/28/96	REPLY BRIEF on behalf of Appellant Commissioner IRS, Copies: 9, Delivered by mail, filed. Certificate of service date 10/28/96. (bmh)
12/18/96	CALENDARED for Thursday, March 13, 1997. (wab)
3/13/97	ARGUED 3/13/97 Panel: Mansmann, Lewis and Michel, Circuit Judges. (agb)
4/24/97	PUBLISHED OPINION (Mansmann, Authoring Judge, Lewis, Michel*, Circuit Judges), filed. *Honorable Paul R. Michel of the US Court of Appeals for the Federal Circuit, sitting by designation. (awi)
4/24/97	JUDGMENT, Reversed. Costs taxed against Appellee, filed. (awi)
5/7/97	BILL OF COSTS filed by Appellant Commissioner IRS. Certificate of service dated 5/5/97 (awi)
6/16/97	MANDATE ISSUED, filed. (awi)
7/10/97	REPORTER at 111 F.3d: 1056 (rmg)
7/28/97	Supreme Court of U.S. notice filed advising petition for writ of certiorari filed in the Supreme Court on 7/22/97

	at Supreme Ct. case number: 97-147. (ctc)
10/22/97	U.S. Supreme Court order dated 10/20/97 at S.C. number: 97-147, granting petition for writ of certiorari. filed. (ctc)

UNITED STATES TAX COURT

ATLANTIC MUTUAL INSURANCE COMPANY and Includible Subsidiaries,	)	
Petitioner,	)	Docket No.
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

PETITION

The Petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue (the "Commissioner") in her statutory notice of deficiency dated September 23, 1993 (Symbols A:NWK:JTI:GT:90D), and as the basis for its case alleges as follows:

1. Atlantic Mutual Insurance Company ("Petitioner") is a corporation with its mailing address and principal office located at Three Giralda Farms, Madison, New Jersey 07940. Petitioner's employer identification number is 13-4934590. Petitioner is, and at all times relevant to this Petition was, the common parent of an

affiliated group of corporations which filed consolidated federal income tax returns pursuant to sections 1501 through 1504 of the Internal Revenue Code of 1986, as amended (the "Code"),* for the taxable year ending December 31, 1987 (the "taxable year 1987") and for the taxable year ending December 31, 1988 (the "taxable year 1988"). During those years the affiliated group consisted of Petitioner and eight includible corporations. A list of the includible corporations is included in the Appendix to this Petition (the "Appendix") and is marked Exhibit A. On or about August 10, 1993 Petitioner filed an amended return (Form 1120X) for the taxable year 1988 in which it claimed a refund of $122,781. The consolidated returns for the taxable years 1987 and 1988 and the Form 1120X for the taxable year 1988 were timely filed with the Internal Revenue Service Center in Holtsville, New York.

2. The statutory notice of deficiency is dated September 23, 1993 and was issued by the office of the Internal Revenue Service in Newark, New Jersey. A copy of the statutory notice of deficiency, including all accompanying statements and schedules, is included in the Appendix and is marked as Exhibit B.

3. The deficiency determined by the Commissioner is in income tax for the taxable years 1987 and 1988, in the amounts of $519,837 and $610, respectively. All of the deficiency of $519,837 for the taxable year 1987 is in controversy.

* All section references, unless otherwise indicated, to the Code.

4. The determination of tax set forth in the notice of deficiency is based upon the following errors:

a. The Commissioner erred in determining that Petitioner's consolidated taxable income for 1987 should be increased by $1,339,039 to reflect her determination that the unpaid losses and unpaid loss adjustment expenses at December 31, 1986 reported by Petitioner and Centennial Insurance Company ("Centennial") included amounts constituting "reserve strengthening" within the meaning of section 1023(e)(3)(B) of the Tax Reform Act of 1986, Public Law 99-514.

b. The Commissioner erred in determining that Petitioner's consolidated income tax liability for the taxable year 1987 should be increased by $1,607, the amount of environmental tax under section 59A attributable to the net "reserve strengthening" adjustment of $1,339,039.

5. The facts upon which the Petitioner relies, as the basis for its case, are as follows:

a. Petitioner and Centennial (collectively, the "Companies") are property and casualty insurance companies subject to tax under section 831.

b. Pursuant to the transitional rule in section 1023(e)(2) of the Tax Reform Act of 1986, the Companies computed their deductions for losses incurred for the taxable year 1987 by adding the amount of net losses paid during the year to the discounted amount of unpaid losses and unpaid loss adjustment expenses at December 31, 1987 and by subtracting from the resulting sum the discounted amount of unpaid losses and unpaid loss adjustment expenses at December 31, 1986.

c. Pursuant to the fresh start rule described in section 1023(e)(3)(A) of the Tax Reform Act of 1986, the Companies were not required to take into account for purposes of the Code the difference between the undiscounted and discounted amounts of unpaid losses and unpaid loss adjustment expenses at December 31, 1986.

d. Respondent determined that a portion of the Companies' unpaid losses and unpaid loss adjustment expenses at December 31, 1986 represented "reserve strengthening" and computed a decrease in the Companies' deductions for losses incurred for the taxable year 1987 in the aggregate amount of $1,339,039.

e. The Companies' unpaid losses and unpaid loss adjustment expenses at December

31, 1986 represented fair and reasonable estimates, based upon the facts in each case and the Companies' experience with similar cases.

f. The Companies' estimates of unpaid losses and unpaid loss adjustment expenses at December 31, 1986 were prepared by use of the same assumptions and methods that the Companies used to estimate unpaid losses and unpaid loss adjustment expenses in the years preceding 1986.

g. The Companies' estimates of unpaid losses and unpaid loss adjustment expenses at December 31, 1986 were not increased artificially, for tax purposes or otherwise.

h. The Companies' estimates of unpaid losses and unpaid loss adjustment expenses at December 31, 1986 did not include any amounts of "reserve strengthening" within the meaning of section 1023(e)(3)(B) of the Tax Reform Act of 1986.

Wherefore, Petitioner prays that this Court hear this proceeding and determine that there is no deficiency in Petitioner's income tax for the taxable year 1987 and that

Petitioner is entitled to a refund of tax in an amount not less than $16,084 for the taxable year 1987 (plus interest thereon as provided by law), and that this Court grant such other further relief to Petitioner as this Court may deem proper.

Respectfully submitted,

/s/ Peter K. Lathrop
Peter K. Lathrop
T.C. No. LP0024

/s/ John S. Breckinridge, Jr.
John S. Breckinridge, Jr.
T.C. No. BJ0916

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Attorneys for Petitioner
Atlantic Mutual Insurance Company

Dated: December 3, 1993

ATLANTIC MUTUAL INSURANCE COMPANY
V.
COMMISSIONER

EXHIBIT A

ATLANTIC MUTUAL INSURANCE COMPANY

List of includible corporations for the taxable years ended December 31, 1987 and December 31, 1988

Corporation	*EIN*
Atlantic Mutual Insurance Company (common parent corporation)	**13-4934590**
Centennial Insurance Company*	**13-6104845**
Atlantic Lloyds Insurance Company of Texas	**74-2197692**
Atlantic 45 Wall Street, Inc.	**13-3381123**
Atlantic Holding Corporation	**13-3332001**
Atlantic Management Services, Inc.	**13-3331999**
Atlantic Reinsurance Company	**13-3362309**
Atlantic Specialty Lines Insurance Company	**86-0592933**
Centennial Holding Corporation	**22-2848453**

*** Centennial Insurance Company is incorrectly identified on page 2 of the notice of deficiency as Continental Insurance Co.**

ATLANTIC MUTUAL INSURANCE COMPANY
V.
COMMISSIONER

EXHIBIT B

The Notice of Deficiency was intentionally omitted. It is reproduced in its entirety in the parties' Joint Appendix in the Court of Appeals for the Third Circuit at page 10.

UNITED STATES TAX COURT

ATLANTIC MUTUAL INSURANCE COMPANY and INCLUDIBLE SUBSIDIARIES,	)	
Petitioner,	)	
v.	)	Docket No. 25767-93
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

ANSWER

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1. through 3. Admits.

4. Denies.

5. (a) Admits.

(b) Admits, except denies that petitioner's actions were pursuant to the transitional rule of Tax Reform Act of 1986 section 1023.

(c) Denies.

(d) Admits.

(e) Denies.

(f) Admits.

(g) and (h) Denies.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

WHEREFORE, it is prayed that respondent's determination, as set forth in the notice of deficiency, be in all respects approved.

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Acting Chief Counsel
Internal Revenue Service

OF COUNSEL:
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Regional Counsel
MATTHEW MAGNONE
District Counsel

By: /s/ William S. Garofalo
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Special Litigation Assistant
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Newark, New Jersey 07102-5224
Tel. No. (201) 645-3047

By: /s/ Patrick E. Whelan
PATRICK E. WHELAN
Assistant District Counsel
Tax Court No. WP0082

DATED: JAN. 27, 1994

UNITED STATES TAX COURT

ATLANTIC MUTUAL INSURANCE COMPANY and Includible Subsidiaries,	)	
Petitioner,	)	
	)	Docket No.
v.	)	25767-93
	)	Judge Chiechi
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

STIPULATION OF FACTS

Pursuant to Rule 91 of the Rules of Practice & Procedure of the United States Tax Court (Tax Court Rules), the parties stipulate for the purpose of this case that the following facts are true and correct and that the exhibits attached hereto are accurate copies of the original documents, which may be considered authentic. Except where the parties have specifically stipulated that the information in those exhibits is true and correct, the parties reserve the right to introduce other evidence consistent with the following facts either to corroborate or to rebut the truth and/or accuracy of the information in those exhibits. All evidentiary objections are waived unless reserved or expressed herein.

1. Atlantic Mutual Insurance Company ("Atlantic") is the common parent of an affiliated group of corporations within the meaning of IRC Section 1504(a)[1] which filed consolidated federal income tax returns for the taxable years involved in the petition, 1987 and 1988, with the office of the Internal Revenue Service ("Service") in Holtsville, New York. The relevant portions of such returns are annexed and marked as Exhibits 1-A and 2-B. In addition, Atlantic filed an amended return for the taxable year 1988 with the same office of the Service, a copy of the relevant portion of which is annexed and marked as Exhibit 3-C. Each party reserves the right to supplement Exhibits 1-A through 3-C. At the date of filing the petition herein, Atlantic's principal place of business was located in Madison, New Jersey.

2. Respondent timely issued a notice of deficiency to petitioners[2] on September 22, 1993, a copy of which is annexed and marked Exhibit 4-D, determining a deficiency of corporate federal income tax in the amount of $519,987 for petitioner's taxable year 1987 and $610 for petitioner's taxable year 1988. Petitioner did not petition the latter deficiency in tax.

3. Atlantic was organized under the laws of New York in 1842 as a mutual marine insurer. Atlantic limited its insurance underwriting activities to ocean marine

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[1] All references to "IRC" are to the Internal Revenue Code of 1954, as amended and in effect in these years, or to the Internal Revenue Code of 1986, as amended and in effect in these years.

[2] Hereinafter, petitioners shall be referred to as "petitioner."

business until 1931. After that date Atlantic expanded its insurance underwriting activities which for the years involved in the petition included most lines of insurance business available to a property and casualty ("P/C") insurer.

4. As permitted by then section 831(c), added by the Revenue Act of 1962, Atlantic elected for taxable years beginning after 1962 to continue to be subject to tax under subchapter L, part III, sections 831 *et seq.*, as a mutual marine insurer rather than under part II of such subchapter applicable to mutual insurers other than life and non-electing mutual marine insurers.

5. Centennial Insurance Company ("Centennial"), a P/C insurer wholly owned by Atlantic, was included in the consolidated federal income tax returns for the taxable years at issue filed by Atlantic. Since the issue raised in the petition herein applies equally to Centennial as to Atlantic, reference hereinafter to "petitioner," unless the context indicates otherwise, shall mean Atlantic and Centennial.

6. As shown in Exhibit 4-D, respondent determined that petitioner had understated its taxable income by the amount of $1,339,039 for its 1987 taxable year. That amount is the discount attributable to net additions that respondent determined had been made by petitioner in 1986 to its unpaid losses and unpaid loss adjustment expenses for pre-1986 accident years. Respondent maintains that this amount must be included in income under section 1023(e)(3)(B) of the Tax Reform Act of 1986, Pub. L. 99-514, section 1023(e)(3)(B) (the prohibition against fresh start for reserve strengthening). The schedules attached to Exhibit

4-D compute that adjustment to petitioner's taxable income according to Treas. Regs.[3] sections 1.846-3(c)(1) and (3). While those schedules do not include the computation of the adjustments to the Schedule O lines of business,[4] a schedule that computes the adjustment to petitioner's taxable income according to Treas. Regs. sections 1.846-3(c)(1) and (3) is annexed hereto as Exhibit 5-E.

7. To determine if petitioner had strengthened loss reserves as of December 31, 1986 for accident years 1985 and prior, respondent applied a mechanical test now set forth in Treas. Regs. section 1.846-3(c)(3) to petitioner's loss reserves at December 31, 1986, subject to the limitation set forth in Treas. Regs. section 1.846-3(c)(1).[5]

The result was that respondent found that petitioner had strengthened loss reserves at December 31, 1986 as follows:

---

[3] References herein to "Treas. Regs." or "Prop. Regs." shall be to Regulations or Proposed Regulations, respectively, promulgated by the Department of Treasury.

[4] For a description of the differences between Schedules O & P, see paragraph 15, below.

[5] Treas. Reg. section 1.846-3(c)(1) provides, in pertinent part, that:

> The amount of reserve strengthening for an unpaid loss reserve may not exceed the amount of the reserve, including any undiscounted strengthening amount, as of the end of the last taxable year beginning before January 1, 1987.

Line of Business	Reserve Strengthening (Weakening)
Auto Liability	$(10,559,423)
Other Liability	(1,279,374)
Workers' Compensation	4,691,659
Multiple Peril	15,585,877
Schedule O (1985)	(3,870,000)
Schedule O (pre-1985)	1,984,000
Total	$ 6,552,739

8. The portion of the above reserve strengthening (weakening) representing discount computed by respondent as shown in Exhibit 4-D and proposed to be included in petitioner's 1987 taxable income for purposes of the prohibition against fresh start for reserve strengthening is as follows:

Line of Business	Fresh Start Adjustment
Auto Liability	$(1,211,842)
Other Liability	(309,970)
Workers' Compensation	1,211,652
Multiple Peril	1,783,897
Schedule O (1985)	(239,446)
Schedule O pre-1985)	104,748
Total	$ 1,339,039

9. The formula set forth in the Treas. Reg. section 1.846-3(c)(3), applicable to unpaid losses as of

December 31, 1985, was applied by respondent by line of business to each pre-1986 accident year contained in the line of business. That formula is: December 31, 1986 unpaid losses by line of business by each pre-1986 accident year, less the net amount of the December 31, 1985 unpaid losses by line of business by accident year reduced by payments during 1986 on the December 31, 1985 unpaid losses by line of business by accident year. If the formula produced a positive number for a given accident year, that amount was reserve strengthening. If the formula produced a negative number for a given accident year, that amount was reserve weakening. The amount of strengthening for a given pre-1986 accident year was, in all events, limited to the amount of the December 31, 1986 unpaid losses for that accident year.

10. Respondent did not propose any reserve strengthening (weakening) adjustment to petitioner's estimates of its December 31, 1986 unpaid losses for the accident year 1986.

11. During the years involved herein, petitioner was (and currently is) licensed to do a P/C insurance business in all states of the United States, the District of Columbia, Puerto Rico and the United Kingdom. In addition, petitioner had (and continues to have) operations in Canada and the Netherlands.

12. P/C insurers must file an Annual Statement in the format prescribed by the National Association of Insurance Commissioners ("NAIC") with the state insurance commissioner for each state in which the P/C insurer is licensed to do business. The NAIC Annual

Statement accounting principles are generally incorporated, with qualification, into the IRC sections applicable to P/C insurers, specifically including IRC section 832(b)(1)(A) and section 846(f)(3). A primary purpose of the NAIC Annual Statement is to provide the state insurance commissioner information about the P/C insurer's financial condition.

13. For the years 1985 through 1993, the NAIC Annual Statement included a balance sheet, statement of income, a capital and surplus account, statement of cash flow, an underwriting and investment exhibit, historical data, numerous schedules and responses to questions, as well as information on premiums, losses, and dividends to policyholders. Petitioner filed its NAIC Annual Statements with the insurance department of each State in which it was licensed to do an insurance business for the years 1985 through 1993.

Copies of Annual Statements of petitioner for the years 1985, 1986, 1987, 1988, and 1993 are annexed hereto and marked as follows:

EXHIBIT NUMBER	*YEAR*	*COMPANY*
6-F	1985	Atlantic
7-G	1985	Centennial
8-H	1986	Atlantic
9-I	1986	Centennial
10-J	1987	Atlantic
11-K	1987	Centennial
12-L	1988	Atlantic
13-M	1988	Centennial
14-N	1993	Atlantic
15-O	1993	Centennial

14. P/C insurers report on their Annual Statements estimates of amounts (including unpaid losses and unpaid loss adjustment expenses) that they expect to pay in the future for, or in respect of, losses that have already occurred. These estimates are commonly called "loss reserves" or simply "reserves."[6] P/C insurers were (and are) required to maintain reserves estimated to be sufficient in amount 1) to ensure the payment of claims by insureds and third parties that have occurred but not yet been paid by or not yet been reported to the insurer; and 2) to enable the insurer to pay for the costs of resolving, i.e., adjusting, such claims. The amounts of such reserves were required to be determined at the date, typically December 31, as of which the Annual Statement was required to be prepared.

15. Generally, P/C insurers account for loss reserves by separate lines of business and report statistics for each line by accident year. A line of business is a category used for reporting, among other things, losses on the basis of the insurer's Annual Statement. An accident year generally is the calendar year in which the incident occurs giving rise to a claim. Schedules O and P of the Annual Statement contain data on losses by accident year by line of business. Schedule P includes lines of business that often generate longer term liabilities for losses ("long-tailed lines" of business).

[6] IRC section 832(c)(4) allows P/C insurers a deduction for "losses incurred," a portion of which is comprised of estimated unpaid losses. Unpaid losses are estimates of amounts of costs that will be paid in the future on loss events that have occurred, and they are commonly called "reserves."

16. Petitioner's reserves for unpaid losses consisted of three elements: 1) Estimates of the amounts to be paid on claims reported to petitioner (case reserves); 2) Estimates of amounts to be paid on losses which had occurred but which had not yet been reported to petitioner (Incurred But Not Reported or simply "IBNR" reserves); 3) Estimated amounts to be paid in the course of settling or otherwise resolving the losses included in (1) and (2) (reserves for loss adjustment expenses ("LAE")).[7]

17. P/C insurers use a wide range of approaches to estimate loss reserves, often relying on different approaches for different lines of business offered by the same P/C insurer. Petitioner objects to this paragraph as irrelevant.

18. P/C insurers generally establish case reserves by using estimates of individual claims made by individual claims adjusters, whose estimates are usually revised over time according to the available information and individual judgment and experience of the adjuster.

19. Although a P/C insurer knows that IBNR losses have occurred, by definition, the insurer does not have information about the loss events on which to base an estimate of the amount of each loss. Accordingly, the insurer must use another method according to its judgment

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[7] As of January 1, 1987, for federal income tax purposes, P/C insurers include unpaid LAE as part of their unpaid losses under IRC § 832(b)(5) and reference to "losses" hereinafter shall be deemed, unless the context requires otherwise, to include LAE.

and experience rather than individual case estimates to determine its IBNR reserves.

20. For Annual Statement purposes, P/C insurers use a multitude of methods for estimating IBNR reserves. Some P/C insurers estimate IBNR reserves by estimating ultimate losses to be incurred for an accident year projected by "link ratios,"[8] then subtracting paid losses to date and case estimates of reported losses. The remainder is treated as the IBNR reserve. Other P/C insurers' estimates are based on past experience developing the IBNR reserve as a percentage of earned premiums, which percentage is applied to current year earned premiums. Another method is to project IBNR reserves based upon past accident year data by link ratios. Still another method is simply to determine the dollar value of late reported losses in prior taxable years and, using judgment and experience, translating that dollar value to a dollar value for the current IBNR reserve. Petitioner objects to this paragraph as irrelevant.

21. P/C insurers compute reserves for unpaid loss adjustment expense (LAE) reserves in a variety of ways. Unpaid LAE are commonly divided between: (a) allocated (ALAE) and (b) unallocated (ULAE). Unpaid ALAE consists of expenses which can be assigned to individual claims (e.g., legal fees and costs), whereas unpaid ULAE (e.g., rent allocable to the Claims Department) cannot be assigned to a specific claim.

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[8] The "link ratio" method assumes that recorded amounts grow in a stable manner from one period of development to another. This method uses the growth rates (called "link ratios" or age-to-age development factors) to project final values for losses.

22. To estimate unpaid LAE reserves, P/C insurers often use a formula based on the ratios of allocated LAE payments to loss payments and of unallocated LAE payments to loss payments.

23. Exhibit 16-P annexed hereto sets forth the amounts of unpaid losses estimated by petitioner per its Annual Statements for 1985 and 1986, respectively. Exhibit 17-Q annexed hereto sets forth the amounts of loss adjustment expenses estimated by petitioner per its Annual Statements for 1985 and 1986,[9] respectively.

24. Exhibit 18-R annexed hereto accurately sets forth the amounts that petitioner paid in subsequent years through 1993 in respect of the unpaid losses (and loss adjustment expenses) described in Exhibit 16-P and 17-Q and paragraph 23, above, and the estimated amounts of such losses (and loss adjustment expenses) remaining unpaid at December 31, 1993. The aggregate of the amounts paid and estimated amounts remaining to be paid as of December 31, 1993 shown in Exhibit 18-R exceed the estimated unpaid losses at December 31, 1985 and 1986 by $84,598,000 and $88,847,000, respectively. Thus, as of December 31, 1993, both the December 31, 1985 and the December 31, 1986 loss reserves were underestimated as of December 31, 1985 and December 31, 1986. Thus, petitioner's aggregate December 31, 1986 loss reserves, on a hindsight basis through December 31, 1993, were, from an actuarial standpoint, estimated to be more inadequate by $4,249,000 when compared to petitioner's aggregate

[9] The 1986 unpaid losses include those for the accident year 1986.

December 31, 1985 loss reserves. The estimated amount of increased inadequacy is the excess of the underestimation in the 1986 reserves, $88,847,000, over the underestimation in the 1985 reserves, $84,598,000, as of December 31, 1993. The amounts of underestimation were deducted for federal income tax purposes on or before December 31, 1993. Respondent objects to this paragraph and this exhibit as irrelevant.

26. Petitioner's unpaid losses consisted predominantly of case reserves. Case reserves were the aggregate of estimates of the amounts to be paid on each individual claim reported to petitioner.

27. Typically, when a claim was reported to petitioner, it was assigned to a claims adjuster who promptly evaluated the available information, checked coverage, investigated facts, determined the injury or damage, created the claim file, assigned a claim number, made sure that the claim was entered in petitioner's data processing system, and attempted to resolve the claim. The claims adjuster, based upon experience and judgment, was required to estimate the ultimate amount, if any, payable by petitioner, i.e., the case estimate.

28. The individual case estimates were made by individual claims adjusters in petitioner's Claims Department, or independent claims adjusters, from data derived from loss reports to and policy files of petitioner, taking into account petitioner's prior experience with similar claims. Estimates of the amount of each claim were made independently of other current claims and were based upon the facts and circumstances of each such claim. When

additional information was reported to petitioner on an individual claim, the case estimate was reevaluated, but not necessarily changed, by the claims adjuster. In every case, petitioner's system scheduled each claim for reexamination at six month intervals.

29. As described above, petitioner's case reserves were established using the same methodology as of December 31, 1985 and as of December 31, 1986. Management of petitioner did not attempt in any way to influence estimates made, or to be made, by the individual adjusters in petitioner's Claims Department or by independent claims adjusters employed by petitioner as independent contractors in establishing petitioner's case reserves as of either December 31, 1985 or December 31, 1986. Petitioner's case reserves reflected in its Annual Statements for 1985 and 1986 amounted to $255,655,141 and $277,705,661, respectively.

30. Petitioner's IBNR reserves were estimated by its Actuarial Department using a so-called "counts and averages" methodology. The methodology was applied separately to each line of insurance business. The number of claims reported in years after the accident year was determined for prior accident years. These counts were used to project the number of claims which would be reported after December 31st for each accident year included in the current loss reserve. Based on historical data, the average cost per late reported claim was also projected. The projected number of claims was then multiplied by the projected average costs per claim to establish a total indicated IBNR reserve for each individual line of business. The amounts thus determined for each individual line of

business were in some cases increased and in others decreased based upon actuarial quarterly reviews of the loss reserves for the prior year. The amounts of the increases and/or decreases were judgmental and determined by senior management. In some instances, the amounts were intended to correct perceived underestimates or overestimates of case reserves in a particular line of business. The net amounts of management adjustments to IBNR were a reduction of $1,200,000 and $100,000 for 1985 and 1986, respectively. The above methodology and judgmental factors were used for each line of insurance business for each of the years 1985 and 1986. In this manner, petitioner established 1985 and 1986 IBNR reserves of $93,713,687 and $111,708,986, respectively. Annexed hereto and marked Exhibit 19-S are Atlantic's schedules showing the adjustments to the actuarially determined 1985 and 1986 IBNR reserves. Annexed hereto and marked Exhibit 20-T are Centennial's schedules showing the adjustments to the actuarially determined 1985 and 1986 IBNR reserves.

31. Petitioner's ALAE reserves for 1985 and 1986 were established partly by individual case estimate, partly by formula, and partly by judgmental factors.

32. Beginning with claims open at December 31, 1984, petitioner's claims adjusters estimated the legal expense portion of ALAE on an individual case basis for those claims involved in litigation. Thus, legal expenses on claims involved in litigation and open at December 31, 1985 and at December 31, 1986 were estimated on a case basis.

33. Prior to 1984, a ratio of paid ALAE to paid losses for the three years prior to the current year, i.e., 1980, 1981 and 1982 for 1983, was determined. The unpaid ALAE were determined by applying eighty-five percent of this ratio to case estimates and 100% of the ratio to IBNR. The sum of the two amounts was the unpaid ALAE. This procedure was used for 1984, 1985 and 1986 IBNR. For 1984, 1985 and 1986 case reserves, the paid legal expenses were excluded from the paid ALAE in the paid to paid ratio applied to case estimates of unpaid losses, since case estimates of such expenses were separately determined.

34. Petitioner's methodology and assumptions for determining the ultimate paid to paid ratio and projected ultimate losses, quarterly losses and ALAE reviews were the same for 1984, 1985 and 1986. After the amounts of unpaid ALAE were determined as described in paragraphs 32 and 33, petitioner's senior management increased the 1985 and 1986 ALAE reserves and prior year ALAE reserves by reference to quarterly loss and ALAE reviews. The reviews related to the projected development of the prior year end loss and ALAE reserves. For purposes of the quarterly reviews, the ALAE paid to paid ratios were projected using link ratios to the ultimate paid to paid ratio. This projected ultimate paid to paid ratio was applied to the projected ultimate losses to estimate the ultimate ALAE. Based upon the indicated amount of ultimate ALAE, petitioner's senior management estimated the need for an addition to the ALAE reserve.

35. Petitioner established ULAE reserves by formula. A ratio of three years' paid ULAE to paid losses was applied to 50% of case reserves and to 100% of IBNR

reserves. The same formula was used for the computation of 1985 and 1986 ULAE reserves.

36. Based on the facts described in paragraphs 31, 32, 33, 34 and 35, above, petitioner established LAE reserves amounting to $72,317,450 and $84,066,519, for the years 1985 and 1986, respectively. Attached as Exhibit 21-U are petitioner's schedules detailing the computation of unpaid LAE adjustments for Atlantic, Centennial and, for 1986, Atlantic Reinsurance Company, also.

37. Petitioner's data processing system automatically debited the applicable loss reserve on an individual claim whenever a payment was made on the claim whether the payment was in full satisfaction of the claim or a partial payment. However, as part of approving the payment, the responsible claim adjuster was required to determine whether an adjustment should be made to the loss reserve applicable to the claim. If the adjuster determined prior to, at the same time as or after the payment that the loss reserve should be changed, the adjuster could put through the system a change in the loss reserve, decreasing it by an amount greater than the payment, by an amount less than the payment or even increasing the loss reserve to an amount greater than that before the payment. Where a payment closed a loss, the unpaid amount was reduced to zero without regard to the amount of the payment.

38. Petitioner's total aggregate loss reserves for 1985 and 1986, respectively, amounted to $421,686,277 and $473,481,163, respectively. These totals can be derived from Exhibits 16-P and 17-R. The total

aggregate loss reserves for pre-1986 accident years in the 1986 total aggregate loss reserve of $473,481,163 was $300,181,334 (comprised of the sum of case reserves in the amount of $199,944,208, IBNR reserves of $41,329,506, and unpaid LAE reserves of $58,907,620). As more specifically stipulated in paragraphs 27 through 37, the basic methodologies and assumptions used to arrive at these total reserves as of December 31, 1985 and December 31, 1986, respectively, were the same.

39. While respondent reserves the issue as to whether petitioner engaged in reserve strengthening, respondent admits that petitioner's 1985, 1986, 1987 and 1988 loss reserves, included in its deduction for losses incurred for such years, were, in the aggregate, reasonable, accurately estimated, and complied with the provisions of section 832(b)(5) (and for discounting purposes, section 846) and Treas. Regs. sections 1.832-4(a)(5) and 1.832-4(b), and that petitioner accurately discounted those reserves under § 846. Respondent objects to this paragraph as irrelevant.

40. In the examination of petitioner's returns for the tax years 1986, 1987 and 1988, respondent's agent tested petitioner's unpaid loss reserves for its Schedule P lines of business. Those tests showed that, as of 1988, in the Schedule P lines of petitioner's business, petitioner was overreserved for its losses, but underreserved for its LAE. Because those tests showed, as of December 31, 1988, a deficiency in unpaid LAE in excess of the redundancy for unpaid losses, respondent allowed a deduction for petitioner's loss reserves and LAE reserves as claimed on petitioner's returns for those years. Respondent objects to this paragraph as irrelevant.

41. Petitioner did not increase its loss reserves for 1985 and prior accident years included in its aggregate loss reserves for 1986 for tax motivated purposes. Respondent objects to this paragraph as irrelevant.

42. To petitioner's Actuarial Department, the term "reserve strengthening" meant a change made to the reserves to accomplish an increase in the adequacy (or a decrease in the inadequacy) of such reserves. Petitioner objects to this paragraph as irrelevant.

43. To petitioner's Actuarial Department, the term "reserve weakening" meant a change made to the reserves which decreased the adequacy (or increased the inadequacy) of such reserves. Petitioner objects to this paragraph as irrelevant.

44. As a result of Treas. Reg. § 1.846-3, respondent's examining agent did not examine or attempt to examine individual claim records maintained by petitioner's Data Processing Department in determining whether petitioner strengthened reserves within the meaning of § 1023(e)(3)(B), Tax Reform Act of 1986. Petitioner did not request that respondent undertake such an examination, nor did petitioner offer to do so for this purpose. Respondent objects to this paragraph as irrelevant.

45. Petitioner did (and continues to) maintain detailed claim by claim records on electronic data processing equipment. Petitioner may access each individual record of all reported and directly underwritten claims by appropriate software programs maintained by petitioner. Neither IBNR nor some claims on business which petitioner

assumed by way of reinsurance can be so accessed. Respondent objects to this paragraph as irrelevant.

46. Annexed and marked as Exhibits 22-V through 25-Y are schedules, derived from Exhibit 4-D that compute the reserve strengthening (weakening) determined by respondent for the Automobile Liability, Other Liability, Workers' Compensation and Multiple Peril lines of petitioner's business by accident year and by type of unpaid loss reserve (case and IBNR or LAE).

47. Attached as Exhibit 26-Z is a copy of the preamble to the Regulation, published on September 4, 1992. 57 F.R. 48562 (1992-2 C.B. 146, 148).

48. Attached as Exhibit 27-AA is a copy of the preamble to the Proposed Regulation. Notice of Proposed Rule Making (FI-139-86), 56 F.R. 20161 (1991-2 C.B. 946, 947).

49. The Proposed Regulation was based on Notice 88-100 (the Notice), 1988-2 Adv.Sh.Ed.C.B. 471, a copy of which is attached as Exhibit 28-AB.

50. In discovery in this case, petitioner has requested that respondent produce any document supporting the following statements in the preamble to that Proposed Regulation:

> Because the test is applied to each unpaid loss reserve, rather than to each separate loss, the test does not take into account the fact that a particular loss payment may exceed, or be less than, the initial

> estimate of the loss for which the payment was made. This may result in a failure to include, or an erroneous inclusion of, certain amounts in the computation of reserve strengthening for a particular reserve. For most unpaid loss reserves, however, any potential inaccuracies are likely to offset each other in the aggregate.

Respondent has not produced any document that supports those statements, even though respondent's files contain three memoranda relating to the above statements.

51. For the 1977 accident year in its Auto Liability line of business, petitioner maintains that it held reserves of $44,278 (which include case reserves of $40,026 and unpaid LAE determined by a paid to paid ratio method of $4,252) for unpaid losses as of December 31, 1985, which petitioner maintains were still unpaid and included in unpaid losses at December 31, 1986 in Exhibit 12-L in the amount of $58,918. Respondent objects to this paragraph as irrelevant.

Respectfully submitted,
STUART L. BROWN
Chief Counsel
Internal Revenue Service

/s/ John S. Breckinridge	By: /s/ Phillip A. Pillar
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	Telephone:(215) 597-3922
Date: January 5, 1995	Date: January 6, 1995

UNITED STATES TAX COURT

ATLANTIC MUTUAL INSURANCE COMPANY and Includible Subsidiaries,	)
Petitioners,	)
v.	) Docket No. 25767-93
	) Judge Chiechi
COMMISSIONER OF INTERNAL REVENUE,	)
Respondent.	)

FIRST SUPPLEMENTAL STIPULATION OF FACTS

Pursuant to Rule 91 of the Rules of Practice & Procedure of the United States Tax Court (Tax Court Rules), the parties stipulate for the purpose of this case that the following facts are true and correct and that the exhibits attached hereto are accurate copies of the original documents, which may be considered authentic. Except where the parties have specifically stipulated that the information in those exhibits is true and correct, the parties reserve the right to introduce other evidence consistent with the following facts either to corroborate or to rebut the truth and/or accuracy of the information in those exhibits. All evidentiary objections are waived unless reserved or expressed herein.

52. Annexed hereto and marked Exhibit 29-AC is a copy of excerpts from petitioner's 1984 claims manual, as provided to respondent in response to informal interrogatories.

53. The sum of the net adjustments made by petitioner's management to petitioner's 1986 LAE reserves in the manner described in paragraph 34 is as follows:

"Safeguard (Pollution)"	450,000
"1986 Bulk Strengthening"	2,700,000
TOTAL	$3,150,000

(Exhibit 21-U, "The Atlantic Companies, LAE Reserves, December, 1986")

54. Annexed hereto and marked respondent's Exhibit AD is a copy of the Congressional Record containing remarks of Senator Malcolm Wallop (R-Wyo) on the limitation of fresh start for reserve

strengthening and the accompanying Conference Committee Report. Petitioner objects to this paragraph and exhibit as irrelevant.

Respectfully submitted,
STUART L. BROWN
Chief Counsel
Internal Revenue Service

/s/ John S. Breckinridge	By: /s/ Phillip A. Pillar
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Date: February 10, 1995 Date: February 9, 1995

UNITED STATES TAX COURT

ATLANTIC MUTUAL INSURANCE COMPANY and Includible Subsidiaries,	)	
Petitioners,	)	
	)	Docket No.
v.	)	25767-93
	)	Judge Chiechi
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

SECOND SUPPLEMENTAL STIPULATION OF FACTS

Pursuant to Rule 91 of the Rules of Practice & Procedure of the United States Tax Court (Tax Court Rules), the parties stipulate for the purpose of this case that the following facts are true and correct and that the exhibits attached hereto are accurate copies of the original documents, which may be considered authentic. Except where the parties have specifically stipulated that the information in those exhibits is true and correct, the parties reserve the right to introduce other evidence consistent with the following facts either to corroborate or to rebut the truth and/or accuracy of the information in those exhibits. All evidentiary objections are waived unless reserved or expressed herein.

55. Annexed hereto and marked as Exhibit 30 is a copy of the expert witness testimony of Irene K. Bass submitted on behalf of petitioners.

56. Annexed hereto and marked as Exhibit 31 is a copy of the expert witness testimony of W. James Mac Ginnitie submitted on behalf of petitioners.

57. Annexed hereto and marked as Exhibits AE and AF, respectively, is a copy of the expert witness testimony of Raymond S. Nichols submitted on behalf of respondent.

58. Annexed hereto and marked as Exhibits AG, AH, and AI, respectively, is a copy of the expert witness testimony of Ruth E. Salzmann submitted on behalf of respondent.

59. The parties accept the qualifications of the expert witnesses as set forth in the above-marked exhibits.

Respectfully submitted,
STUART L. BROWN
Chief Counsel
Internal Revenue Service

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Date: Feb. 22, 1995	Date: February 23, 1995

Report on Reserve Strengthening

Irene K. Bass
December 9, 1994

Purpose

The purpose of this report is to (1) provide background discussion on the processes used by property-casualty (PC) insurers to set reserves[1]; (2) provide background on "reserve strengthening" as the term is used in the context of aggregate loss and loss adjustment expense (LAE) reserves established by PC insurers and reported on their Annual Statements and to provide examples where reserve strengthening exists and where it does not; (3) define reserve strengthening and identify its chief characteristics; and (4) explain why the IRS definition of reserve strengthening does not describe reserve strengthening in the sense that it is used in the PC insurance industry. In the course of doing this, I will incorporate

[1] In this report, *reserve* refers to *loss and loss adjustment expense reserve,* unless otherwise noted. The term refers to the provision for all liabilities for claims incurred, whether reported to the insurer as of the valuation date or not. *Case reserve* refers to individual claim estimates determined by claims adjusters on claims which have been reported to the insurers. *IBNR reserve* refers to a provision for *i*ncurred *b*ut *n*ot *r*eported claims. IBNR can also include a bulk provision for claims that have been closed as of the valuation date but which will reopen in the future. *Case development reserve* refers to a provision for the deficiency (or redundancy) in the aggregate of the case reserves. The case development reserve is sometimes included within the IBNR reserve and not separately identified. The term reserve is the sum of the case reserves, IBNR reserves, and the case development reserves (whether separately identified or included in the broader definition of IBNR).

comments on the decision in the case of *Western National Mutual Insurance Company v. Commissioner of Internal Revenue*, 102 T.C. 338 (1994).

In the course of exploring the concept of reserve strengthening as the term is used in the PC insurance industry and as proposed to be used by the IRS, I provide examples that constitute reserve strengthening and examples that the IRS would consider to be reserve strengthening but which are the result of the routine, periodic re-estimation process inherent in the setting of loss reserves for a PC insurer.

Biographical Summary and Qualifications

My formal education includes a bachelor of arts degree, *magna cum laude*, in mathematics and German from Bowling Green State University and a master of science degree in mathematics from Northeastern University.

I am a Fellow of the Casualty Actuarial Society (CAS) by examination; I am a Fellow of the Canadian Institute of Actuaries, also by examination; and I am a Member of the American Academy of Actuaries.

I have been professionally active continuously since the time of earning my fellowship designation in the CAS and the following summarizes the major aspects of my activity. I served as chair of the Textbook Steering Committee of the CAS from 1985 through 1989, which resulted in the 1989 publication of the first comprehensive textbook on casualty actuarial science. In 1987, I served as president of a CAS regional affiliate, Casualty Actuaries of Greater New York. From 1986 through 1989, I served a three year term as an

elected member of the CAS Board of Directors. From 1989 through 1992, I served a three year term as vice president - continuing education, with responsibility for the continuing education programs and publications of the CAS. In 1992 I was elected by the CAS membership to serve one year as president, and I completed that service in November 1994. During 1992-1993, I also served on the Board of Directors of the CAS and the Board of Directors of the American Academy of Actuaries. During 1994-1995, I will chair the quarterly meetings of the CAS Board of Directors. I have also written several papers contained in various CAS publications, made presentations at actuarial meetings and seminars, and served on various other professional committees.

My work experience includes more than 21 years in actuarial and insurance management positions where I was involved in ratemaking and reserving activities for both primary insurance and reinsurance. For 14 years, I held various positions at three different insurance or reinsurance companies, my most recent position being that of senior vice president at the Crum & Forster Insurance Group. In that position, I served as chief actuary for the personal lines division of Crum & Forster doing business as Crum & Forster Personal Insurance and, at the same time, I had responsibility for underwriting systems and product development.

In 1987, I joined William M. Mercer, Incorporated as a consulting actuary in its PC actuarial practice located in the New York City office. I began as a principal and am currently a managing director of Mercer. During my seven years at Mercer, I have provided consulting services in

reserving, ratemaking, and insurance management related areas to a wide variety of clients including insurers, reinsurers, insurance regulatory authorities, and self-insured entities. My complete biographical sketch is attached as Appendix A to this report.

Section (1) - Background on the Reserve Setting Process for PC Insurers.

Reserves: Basic Terms and Procedures

Loss and LAE reserves are liabilities required to be held by a PC insurer to make sure the company has set aside the money it will need to pay claims that have occurred but have not yet been paid or perhaps not even yet reported to the insurer as of the valuation date.[2] PC insurers must hold such monies because, according to insurance statutory accounting, as of the valuation date they have been permitted to take as income the portion of premium allocated to the expired portion of the policies written in the current or prior years; however, not all of the claims arising out of the expired portions of those policies, *i.e.*, those occurring in accident years[3] ending on or

[2] This report assumes annual valuations coincident with the valuation date of the Annual Statement, which is usually December 31 of each calendar year. Insurers likely re-estimate reserves at interim valuation dates, but the only valuation relevant to the issue at hand is the year-end annual valuation.

[3] *Accident year* is the year in which the insured occurrence took place, regardless of when the accident was reported to the insurer. For example, an auto accident that occurred on December 28, 1993 may not be reported to the insurer until January 2, 1994. In this case, the accident year

before the valuation date, will have been paid or even reported to the insurer as of the valuation date.

For an insurer that is a going concern, at any given valuation date, not all the claims have been reported or exactly determined through the case reserve setting process, and so the insurer cannot record an amount certain for these liabilities but must, instead, estimate them. The reserves of a PC insurer are usually composed of the sum of (1) individual estimates of losses and LAE established by the insurer for claims already reported to it, called case reserves, (2) an aggregate provision for all loss and LAE amounts that will be paid on claims that have already been incurred but have not yet been reported to the insurer (the IBNR reserves), and (3) an aggregate provision for expected future changes in the case loss and LAE reserves arising out of the imprecision in the case reserve setting process, sometimes called a case development reserve.[4]

PC insurers use a wide range of approaches to estimate reserves, often relying on different approaches for different lines of business within the same company. For Annual Statement purposes, reserve setting procedures sometimes establish total reserves indirectly by first estimating ultimate losses and then subtracting the paid losses to arrive at the total reserve. (Or, alternatively, by first estimating ultimate

is 1993, but the report year is 1994. Although an accident year can be defined to be any 12 month period, only accident years that run concurrently with calendar years are considered in this report.

[4] See footnote 1 for an explanation of terms as used hereafter in this report.

losses and then subtracting the sum of the paid losses and the case reserves to arrive at the IBNR reserve which would include a provision for case development.)

A number of insurers, however, establish reserves directly, for example, as the sum of case reserves plus some amount for IBNR reserves (where the IBNR may be a function of time and some other variable such as earned premium or case incurred losses). Regardless of whether reserves are set directly or indirectly, all approaches to estimating loss reserves rely on an element of judgment.

Setting Reserves in a "Perfect World"

As background, it is relevant to consider how the reserve setting process operates in a "perfect world." In a perfect world, the insurer sets completely accurate prices (*i.e.*, premiums). This means the insurer anticipates perfectly the losses and expenses associated with the risks it intends to write for a given time period and includes these provisions in its premiums in a manner which permits the attainment of the target profit.

In this perfect world, at the time each claim is reported to the insurer, the claims adjuster establishes a case reserve which is exactly equal to the amount that will be ultimately paid on the claim. Hence, the only provision that needs to be estimated in bulk is the IBNR provision (which can be established either directly or indirectly as discussed earlier) which relates to the claims which have been incurred but which are still unreported as of the valuation date. Because we are assuming perfect case reserve estimates, there is no need to include a provision for case reserve development.

In this world of perfect information, there are no changes needed to the estimated ultimate incurred losses after the initial valuation. When a claim is reported after the initial valuation date, the IBNR is reduced by exactly the amount of the newly established case reserve for the emerged claim until the IBNR reserve reaches zero at the time when all claims have been reported. When a claim is paid, the case reserve is reduced to zero and the paid amount is exactly equal to the prior existing case reserve. In such a world, the term *reserve strengthening* has no meaning.

Setting Reserves in a World of Uncertainty and Imperfect Information

The insurance world, however, is not perfect. At the time an insurer sets its premiums, it does so prior to knowing exactly how many loss and LAE dollars it will need to pay out for the risks it intends to insure. There can be a great deal of uncertainty about the magnitude of the losses and LAE arising out of the contingent events for which the premiums provide coverage. At the time of the initial valuation of reserves, information received by the insurer is incomplete, imperfect, and still subject to a number of external influences which may result in a need for the insurer to change, from valuation to valuation, its estimate of what the reserves otherwise would have been.

Any number of things can have an impact on the insurance ratemaking and reserving processes, as time passes, causing PC insurers to change their estimates of reserves from what they otherwise would have been. For example, if prices originally thought to be adequate turn out to be inadequate, the insurer may need to set subsequent valuations of reserves

at amounts higher than what they otherwise would have been under the original assumption of premium adequacy.[5] In the case where the insurer assumes the premiums to be adequate at the time of the first valuation, the insurer may have calculated its reserves based on the provision for incurred losses underlying the premium it charged. When it eventually, at some later valuation date, finds the loss experience is emerging at a level higher than originally anticipated, it concludes that the premiums are inadequate and that the provision for losses included in the premium is insufficient. Hence, the insurer will need to establish reserves that are greater than what they would otherwise have been, had the premiums not turned out to be inadequate.[6]

It is not unusual for claims experience to emerge in a manner that shows premiums to be inadequate and for the insurer to need to take a number of corrective actions to increase its reserves from what they otherwise would have been. There are a number of corrective actions that the insurer may take to reflect this new increased claims emergence. For example, the insurer may review its emerging claims

[5] Prices could also turn out to be more than adequate, but since this would result in decreases to what reserves would otherwise have been, this would not lead to reserve strengthening, so this situation is not discussed here.

[6] In this scenario, the insurer initially believed its prices to be adequate, set its reserves based on that assumption, and declared the target profit on its Annual Statement and on its federal income tax return. In reversing its assumption about the adequacy of the premium, it will increase its reserves over the level at which they otherwise would have been established, and it will need to recapture the taxes already paid on the profit that is now reduced through these actions.

experience, increase its estimated ultimate incurred losses and, therefore, increase the amount of IBNR reserves it otherwise would have held. A second alternative would be for the insurer to review its individual case reserves and increase the amounts where appropriate to reflect a more adequate estimate of the case reserves; hence, it may not be necessary to increase the IBNR reserve from what it otherwise would have been if the case reserve changes have accounted for the needed additions. Or the insurer could do some of both in order to achieve the appropriate increase in the reserves from what otherwise would have been held.

In this imperfect insurance world, it could also be the case that premiums were set accurately but something early in the claims reporting process occurs which is out of step with expectations, leading the insurance company initially to underestimate its reserves. For example, it could be that the incidence of claims reported is initially lower than anticipated in the rates; that case reserves were initially set at levels which proved to be too low; or that the insurer underestimated the amount of required IBNR at the initial valuation. Each of these situations would need to be corrected by the insurer at a later valuation date and such correction will result in increases to what the reserves otherwise would have been.

As a final example of something that can operate in a world with imperfect information, suppose that premiums are established exactly accurately and loss reserving at the first valuation date is perfect. Suppose, further, that at some time after the first valuation, a court decision is handed down that changes the company's expectations with respect to the nature of the insurance coverage provided.

A situation such as this occurred in California where a house slid down a hill that was eroded during a sudden and severe rainstorm. The court held that the insurer had to pay not only for the replacement cost of the home, but it also had to pay for the replacement cost of the hill. This was a very new and different interpretation of homeowners coverage by the courts, which PC insurers could not have anticipated at the time of setting premiums, and which will require insurers to pay out more than they estimated as of the prior valuations. In this example, the insurer did everything correctly; it set its prices accurately and it set its reserves exactly. But the court's decision changed the insurer's expectations of the nature of the insurance coverage, and the insurer would now need to revise its prior estimates to reflect this new insurance environment.

The Recursive Nature of Setting Reserves

In the uncertain world of insurance, approaches to estimating reserves range from fairly mechanical to highly judgment-based methods. The method used for a particular line of business for a particular accident year is heavily dependent on the nature of the loss data available at the valuation date. Underlying all methods for estimating reserves, however, is the expectation that the estimates will not be perfectly correct for any accident year until all claims have been reported, closed, and paid. Hence, the reserve setting process is a recursive process which fully anticipates that changes, both favorable and adverse, in the estimates of the reserves will occur from valuation to valuation.

An example of a method which operates routinely with few anticipated revisions in assumptions from initial to final

valuation would be a method applied to a large book of auto physical damage claims. It would not be uncommon, for example, for a PC insurer to establish reserves based on the sum of a fixed dollar reserve amount per outstanding claim as of the valuation date (regardless of the actual value of each particular claim) plus a provision for IBNR based on this same average amount times an expected number of IBNR claims.

Even this simple, relatively mechanical method requires an amount of judgment, such as the judgment used to determine the per claim reserve amount. However, the expectation here is that few revisions to the reserves, either favorable or adverse, will be expected after the initial valuation since these claims settle so quickly as to make such a re-estimation mostly unnecessary.

A reserve setting method which is somewhat mechanical but which has a greater degree of judgment associated with it is a method that could be used to estimate the reserves for a large book of basic limits auto liability policies. Simple link-ratio methods are often used to estimate ultimate incurred losses and, hence, reserves with judgment overlaid to correct for some assumed or observed phenomenon not already reflected in the emerged loss development history.[7]

On the far opposite end of the spectrum are reserve setting techniques based largely on judgment. These methods are often used in situations in which the insurer has just begun to write a new type of policy and historical data are not yet

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[7] The illustrative example in Exhibit 3, to be explained later in the text, uses a link-ratio method of estimating ultimate incurred losses.

available or in which the loss data are so sparse and/or so volatile as to require a considerable amount of judgment to be infused into the process of estimating reserves. An example of this method would be in the area of estimating ultimate incurred losses for an insurer that writes environmental impairment liability insurance.

Regardless of the particular method used to estimate accident year reserves, there is still the expectation that subsequent valuations will require changes, both favorable and adverse, to the estimates of what the reserves otherwise would have been. These changes are normal and expected in the course of the development of loss experience from the initial valuation to the time the last claim is closed and paid. This type of change is very much a part of the routine, normal conduct of the business of PC insurance and rarely, if ever, results in a major change of methods and/or assumptions that produce the magnitude of change that may be associated with what is commonly referred to as reserve strengthening.

Section (2) - Background on Reserve Strengthening and Examples

Uses of the Term Reserve Strengthening with Respect to Reserves in the Annual Statement

Within the context of the reserve setting process, the term *reserve strengthening* is not a well-defined PC insurance or actuarial term of art to be found in PC actuarial, accounting, or insurance regulatory literature. This does not imply, however, that the characteristics of reserve strengthening cannot be identified, although the IRS takes a different view.

The fact that there is no single actuarial dictionary definition of reserve strengthening does not mean that the term cannot be defined in this context; and it does not mean that, because of the lack of an actuarial dictionary definition, *any* and *all* increases, however large or small, in reserves from what they otherwise would have been automatically constitute reserve strengthening.

Although the National Association of Insurance Commissioners (NAIC) does not specifically define this term with respect to reporting requirements for the filing of information in the Annual Statement for PC insurers, the Annual Statement does provide guidelines useful in identifying the characteristics of what PC actuaries refer to as reserve strengthening.

Annual Statement Schedule P Interrogatories require the disclosure of "any especially significant events, coverage, retention or accounting changes which have occurred which must be considered when making such [loss reserve] analyses." Such language, although it does not reference reserve strengthening (or weakening) by name, suggests that unusual and significant aspects associated with reserves changes are to be associated with reserve strengthening (or weakening) rather than the routine, normal, and very much expected increases and/or decreases to reserves from the application of the necessarily recursive reserve setting process that occurs from valuation to valuation.

The NAIC requires the Annual Statement to incorporate a statement of actuarial opinion on the adequacy of the reserves as an integral part of the Annual Statement. The accompanying instructions to the Annual Statement set forth

in writing in Paragraph 13 what had long been the understanding among PC actuaries with respect to reserve strengthening (or weakening). This language states:

> *The actuary should describe the actuarial assumptions and/or methods which have been used. If there has been any material change in the actuarial assumptions and/or methods from those previously employed, that change should be described in the statement of actuarial opinion by inserting a phrase such as: "A material change in actuarial assumptions (and /or methods) was made during the past year, but such change accords with accepted loss reserving standards."*

While this language does not specifically reference the term *reserve strengthening* (or weakening), it clearly references a material, significant change and does not refer to the valuation-to-valuation modifications that are inherent and expected in the recursive process of setting reserves as time passes.

In addition to the guidance from the Annual Statement, the characteristics of reserve strengthening can be identified by example. It would be possible to describe factually a scenario in which a PC insurer's reserves were increased from what they otherwise would have been and where there could be near universal agreement among PC actuaries and insurance regulators that reserve strengthening has occurred. Similarly, it would be possible to describe factually a different scenario in which a PC insurer's reserves were increased from what they otherwise would have been and

where there could be near universal agreement that there had been no reserve strengthening.

The distinguishing factor of the various types of increases in reserves from what they otherwise would have been which clearly represent cases of reserve strengthening and those increases in reserves from what they otherwise would have been which clearly do *not* represent reserve strengthening provide, in a broad sense, a working definition of reserve strengthening. The challenge lies in the range that exists "in between" examples clearly considered to be reserve strengthening and examples clearly considered not to be reserve strengthening. Just as the setting of reserves is based on judgment to some degree, the determination of whether a particular adjustment to reserves constitutes reserve strengthening is based on judgment applied to the specific facts, especially in the "in between" examples.

The fact that some judgment must be used to determine whether or not reserve strengthening has occurred in a given situation does not, in and of itself, negate the concept of reserve strengthening itself nor does it mean that this judgment should be replaced by mechanistic approaches to determining the presence or absence of reserve strengthening, which is the approach supported by the IRS.

The entire reserving process, including the judgment about the overall adequacy of reserves, which must be included in the actuarial opinion on reserves in the PC Annual Statement, is rooted in informed and studied judgments. Actuaries sometimes disagree about the adequacy of an insurer's total reserves; so it is no surprise that the determination of the presence of reserve strengthening is also

rooter in informed actuarial judgments. Suggesting that a totally mechanistic approach to determining the presence of reserve strengthening should replace the studied judgment of skilled actuaries in making that decision would be similar to requiring that the loss reserves themselves be calculated according to some rigid formula set out in a computer program. The reserve setting process would be ill served to be replaced by a set of rigid formulae, and so the process of determining the presence of reserve strengthening must follow suit.

PC actuaries, who may disagree on whether or not reserve strengthening has occurred in a particular situation, also may agree broadly on the general characteristics of what does (and, conversely, what does not) constitute reserve strengthening. It appears that the lack of a well recognized definition of reserve strengthening in PC insurance literature can be attributed to the recursive nature of the reserve setting process and the fact that identification of reserve strengthening is not a requirement of the normal process of setting reserves.

In the PC insurance industry, the determination of whether reserve strengthening has occurred is, ultimately a matter of actuarial judgment especially for the "in between" situations. While there may be disagreements about whether or not reserve strengthening has taken place in the "in between" situations, there would be far less disagreement among actuaries over the general characteristics of reserve strengthening. What is clear is that actuaries would agree that all net increases to reserves from what they otherwise would have been are not necessarily instances of reserve strengthening. The term *reserve strengthening* cannot, under

any uses of the term, be equated with all net increases to reserves from what they otherwise would have been. Some net increases constitute reserve strengthening; others do not.

Colloquial Uses of the Term Reserve Strengthening

One should be careful to distinguish reserve strengthening as that term is used by PC actuaries and the type of reserve strengthening that is sometimes references by persons who do not establish total loss reserves as presented in the Annual Statement of a PC insurer. Use of the term *reserve strengthening* can vary greatly among those responsible for setting only part of the reserve.

To a claims manager, reserve strengthening could mean a one-time review of all pending claim s(or some well-defined portion of all pending claims) for purposes of improving the degree of adequacy of case reserves and making changes (increases or decreases) where necessary to reflect a more accurate estimate of the expected ultimate payment of each claim. A claims manager's view of reserve strengthening is influenced by the fact that he/she is responsible only for the case reserves rather than the total reserves of the insurer.

Another example is the insurance financial executive who may refer to an increase in the overall level of IBNR reserves as reserve strengthening independent of any change in aggregate case reserves. This financial executive's view of reserve strengthening is influenced by the fact that he/she is responsible only for the IBNR, exclusive of the case reserves. Reserve strengthening can occur, however, only if one considers the combined net effect of changes to both case reserves and IBNR, for if one element of the reserve (*e.g.*, the

IBNR) increases from what it otherwise would have been, while the other (*e.g.*, the case reserves) decreases from what it otherwise would have been in an equal and offsetting amount, there is no reserve strengthening.

In addition to those mentioned above who would give partwise meaning to the term *reserve strengthening*, there are those who have less of a technical background in PC insurance and who sometimes completely misuse the term reserve strengthening. Insurance analysts for investment firms, for example, occasionally refer to any increase in the reserve inventory from calendar period to calendar period as reserve strengthening. Suppose Company A had reserves of $800 million as of calendar year-end 1985, paid $650 million during calendar year 1986, and at calendar year-end 1986 now has $1,010 million in reserves. This phenomenon has sometimes been called reserve strengthening by the actuarially uninitiated even though this situation could represent reserve weakening.

Exhibit 1 presents detail for an example which illustrates this phenomenon. In this example, the estimated total incurred losses for each of accident years 1983 through 1985 have changed from the prior valuation, but the addition of the new accident year 1986 with its growth in premium and its attendant growth in estimated ultimate incurred losses causes the calendar year arithmetic to show the reserve changes from $800 million at year-end 1985 to $1,010 million at year-end 1986.

According to the interpretation of the insurance analyst described above, there would be reserve strengthening because the reserves increased from $800 million at year-end

1985 to $1,010 million at year-end 1986. According to the IRS, there would be reserve strengthening because the estimated ultimate incurred losses for accident years 1985 and prior change from $1,750 million as of year-end 1985 to $1,760 million as of year-end 1986. As will be explained later in this report, both are wrong. This is not an example of reserve strengthening.

Financial analysts frequently use the term reserve strengthening to mean an increase in the ratio of total year-end reserves to earned or written premium. This, too, is likely not to constitute true reserve strengthening. Exhibit 2 illustrates this situation. As of year-end 1985, the insurer's reserves are $1,295 million and the earned premium for 1985 is $610 million, resulting in a reserves-to-premium ratio of 2.12. During the years 1981-1985, this insurer's premiums were constantly adequate, resulting in approximately a 75% loss ratio each accident year.

In 1986, however, the insurer finds itself writing business which is far less adequately priced than in prior years and anticipates that its ultimate loss ratio will be 90% for accident year 1986. The insurer sets its 1986 reserves at a level that will produce this anticipated loss ratio. During calendar year 1986 the insurer pays claims on pre-1986 accident years but does not change any of the pre-1986 accident year estimates of ultimate incurred losses. At year-end 1986, the reserve is $1,595 million and the 1986 earned premium is $700 million producing a reserves-to-premium ratio of 2.28. According to some financial analysts, this increase in the reserves-to-premium ratio constitutes reserve strengthening although the estimates of ultimate incurred losses for pre-1986 accident years have not changed at all

and the reserves for pre-1986 accident years have not changed from what they previously were expected to be at year-end 1986.

The above situations and illustrative examples in Exhibits 1 and 2 suggest that the term "reserve strengthening" is sometimes misused depending upon the part of the reserve for which the person is responsible and also depending on the (lack of) technical background of the person using the term. However, these are colloquial uses of the term "reserve strengthening" and do not describe reserve strengthening as that term applies in the context of establishing the aggregate reserve reported on the Annual Statements of PC insurers by qualified loss reserve actuaries.

An Example Which Illustrates Reserve Strengthening and Some Which Do Not.

It would be useful at this point in the discussion to explore examples which constitute reserve strengthening and some which do not, in anticipation of constructing a working definition of the term and identifying its chief characteristics.

With respect to reporting loss reserves in the Annual Statement, reserve strengthening refers to a one-time or extraordinary, non-periodic action with respect to changes in reserves based on a recognition of a need for changes in the assumptions and methodologies used to compute the reserves and which results in a material increase to the relative level of adequacy of the total reserve inventory.[8] This is markedly

[8] An increase in the relative level of adequacy of the reserves could also be interpreted as a lessening of the level of inadequacy of the reserves.

different from increases made in estimated ultimate losses for prior accident years, or to the estimates of what these reserves otherwise would have been, due to a gradual reflection of developing claims experience or due to a gradual reflection of changes in the judicial or legislative environment which is not reserve strengthening. The former constitutes reserve strengthening; the latter does not.

Recognition by a PC insurer at year-end 1986 that it had significantly underestimated its IBNR for the long-tail lines of business over several annual valuations requiring it to now make a material change in reserving methods and/or assumptions resulting in a subsequent one-time material change in the level of adequacy of its total reserves (*i.e.*, the reserves for all accident years including 1986) is an example of reserve strengthening.

On the other hand, a PC insurer could make a change to accident year estimates of ultimate incurred losses which are not reserve strengthening. The fact that a change is made to a prior accident year's estimated ultimate losses does not mean that the change constitutes reserve strengthening. An example illustrates this.

Exhibit 3 presents an illustrative example of how a PC insurer can change its estimates of ultimate incurred losses for prior accident years and, hence, change its estimates of reserves from what they otherwise would have been. Here the insurer estimates its ultimate accident year losses by application of the most recent three year average cumulative link ratio to the most recent valuation of case incurred losses. While this is a simplification of the actuarial estimation

process, it is not far from a basic method used by a wide variety of PC insurers.

Exhibit 3 Sheet 1 summarizes the emergence over time of an insurance company's case incurred losses through year-end 1985. The upper portion of Sheet 1 contains a "loss development triangle" for case incurred losses. The right hand portion shows the paid losses for each of the accident years valued as of year-end 1985. The lower portion of Sheet 1 displays the resulting link ratios on a valuation-to-valuation basis and on a cumulative valuation-to-ultimate basis.

Exhibit 3 Sheet 2 contains analogous information updated for the year-end 1986 valuation and also contains loss data for the new accident year 1986. The link ratios calculated from Sheet 2 are based on the same methods and assumptions as in Sheet 1 representing the 1985 year-end valuation.

Exhibit 3 Sheet 3 displays results of a calculation of the estimated ultimate incurred losses and the reserves as of year-end 1985 based on application of the most recent three-year average cumulative link ratios. It also shows a comparison to these same figures valued as of year-end 1986.

While this example is fictitious, it is an illustration of what happens quite frequently in PC insurance companies: the loss development period begins to extend over a longer period than originally measured and anticipated. The difference between Sheet 1 and Sheet 2 is the addition of the 1986 accident year loss data and the development of pre-1986 accident years that took place during calendar year 1986.

The reserve methods used on Exhibit 3 Sheet 2 have not changed from the prior valuation illustrated on Sheet 1. The same three-year average link ratio method is used in 1986 to estimate the ultimate incurred losses for each accident year as was used in 1985, but the data have changed to reflect the experience during calendar year 1986. Yet application of this same methodology results in increased estimated incurred losses, as of year-end 1986, for all pre-1986 accident years with the exception of 1978. The total increase to the estimated incurred losses for pre-1986 years is $2,573 million as shown on Exhibit 3 Sheet 3. The resulting change in the estimated ultimate incurred losses, and hence in the reserves that otherwise would have resulted, does not indicate reserve strengthening as it is known in the PC insurance business.

Another, even simpler example can be constructed to illustrate a phenomenon which is clearly not reserve strengthening. Suppose that a PC insurer considered accident year 1978 to be fully paid and closed as of the year-end 1985 valuation. That is, there are no open case reserves and no provision for IBNR attributable to that accident year as of year-end 1985. During the course of 1986 a new claim emerges for the 1978 accident year and the insurer establishes a case reserve for it. This increase in ultimate incurred losses is not reserve strengthening. The assumptions and methods have not changed; only the loss data have changed. It is also not likely that, if this is the only unanticipated change, that a single change in a case reserve would be so large as to constitute reserve strengthening.

As a final example of a situation which does not constitute reserve strengthening, suppose that, in the course of

rendering a decision about coverage provided under a private passenger auto liability policy, a court decided that if the driver owns two cars than the liability coverage provided is the sum of the coverage of the policies existing on the two cars. This decision is contrary to the manner in which insurance coverage has been interpreted by insurers and by the courts over many years. This example is not fictional. It actually happened and this interpretation of coverage is colloquially referred to as the "stacking of limits."

Since this court decision could potentially apply to many existing outstanding claims still to be settled by insurance companies regardless of the date on which the accident occurred, a PC insurer may need to review its current inventory of open claims and increase certain of them, perhaps significantly, to reflect this new court decision. This increase in the reserves would not constitute reserve strengthening because it does not represent a material change in the reserve setting methods and/or assumptions but, rather, reflects a change in the facts of the situation. The courts have now, by their actions, increased the level at which claims will ultimately be paid, creating an environment which, up until this point, was different from the one understood by insurers when setting case reserves.

Reserve strengthening, on the other hand, refers to an infrequent recognition of the need for increases to reserves to a level higher than what otherwise would have existed had the methodologies and/or assumptions not changed. For example, suppose a PC insurer writes environmental impairment insurance exclusively, began to write it only in 1983, and in 1986, after three years of claims emergence have taken place, realized that the exposure to loss was far

greater than it had anticipated. As a result the PC insurer dramatically increased its reserves from what they otherwise would have been at year-end 1986 as a result of significantly changing its assumptions with respect to both the number of claims and the size of claims expected to arise out of the policies it wrote. This action may constitute reserve strengthening.

Section (3) - Definition of Reserve Strengthening and Identification of Distinguishing Characteristics

Definition of Reserve Strengthening

With the examples of what does and does not constitute reserve strengthening and with the NAIC instructions as background, a more comprehensive working definition of reserve strengthening for PC insurers can be developed. With respect to reporting reserves in the Annual Statement, reserve strengthening is said to have occurred if there is a one-time (or, at least, unusual and non-periodic), significant change in the assumptions and/or methodologies used to compute the reserves which results in a material change to the relative level of adequacy of the total reserve inventory.

Distinguishing Features of Reserve Strengthening

Distinguishing features of reserve strengthening for a PC insurance company are discussed below. In order for reserve strengthening to occur, all of these characteristics must be present.

(*a*) *Reserve strengthening is non-periodic*. Usually PC insurers review their emerging claims experience and estimate their reserves at least annually for Annual Statement purposes, with many insurers performing interim valuations quarterly or monthly for internal management purposes. These periodic reviews usually incorporate additional loss data which have emerged since the date of the last valuation and usually result in the normal, anticipated re-estimation of what the loss reserves should be. This periodic re-estimation process stands in stark contrast to an infrequent or one-time revaluation of reserves to a level greater than what they otherwise would have been and which, if coupled with the other characteristics listed in the definition, can constitute reserve strengthening.

(*b*) *Reserve strengthening involves a material change in methodology and/or assumptions*. As previously discussed, it is fully anticipated that the estimates of reserves will change from valuation to valuation from what they other wise would have been due to the recursive nature of the reserve setting process. For reserve strengthening to occur, the change from one valuation date to the next must involve a material change in methodology and/or assumptions.

In an example cited earlier in this report, an insurer, after three years of loss development, recognizes that its prior assumptions about the number and size of environmental impairment claims were woefully inadequate. If the insurer makes a material change in the number of claims and/or the size of the average claim it ultimately expects to pay, this constitutes a material change in the assumptions underlying the estimation of its loss reserves. If this change in assumptions occurs together with the other characteristics

listed in this section, then this action would result in reserve strengthening.

(*c*) *Reserve strengthening results in a material change in the level of the adequacy of the reserves from what they otherwise would have been.* Changes in an insurance company's accident year estimated ultimate incurred losses are expected to occur over time as part of the recursive process of analyzing developing loss experience and re-estimating the reserves. The resulting changes to what the reserves otherwise would have been, on an all-lines all-accident years combined basis, are usually not significant from one valuation date to the next.

Reserve strengthening, on the other hand, refers to very substantial increases in reserves from what they otherwise would have been--well beyond the normal adjustments, both favorable and adverse, which regular reserve reviews are expected to produce.

(*d*) *Reserve strengthening is a concept that applies to the total year-end reserves of an insurer*. Reserve strengthening can occur only if the entire year-end reserve adequacy of the insurer has increased. With respect to the reserves set in the Annual Statement of a PC insurer, reserve strengthening is not a term that has meaning in a "part-wise" sense. One cannot say that reserves have been strengthened by considering only some part of the reserves. For example, reserve strengthening has not occurred if there is an increase in the adequacy of case reserves but there is no net increase in the adequacy of the total reserve including the IBNR. Also, reserve strengthening has not occurred if there is an increase in the adequacy of the reserves for some accident

years but there is no net increase in the adequacy of the total reserve for all accident years considered in the aggregate.

Because an element of judgment may be involved in determining whether certain specific situations constitute reserve strengthening or not, there may be disagreement among actuaries about whether or not reserve strengthening has occurred. There would, however, be far less disagreement about the general characteristics of reserve strengthening.

Section (4) - The IRS Definition and Use of the Term *Reserve Strengthening*

IRS Definition and Examples

The IRS defines reserve strengthening in its regulations and presents an example, with a series of variations on that example which serve only to illustrate certain specific limitations and exceptional situations. The basic example of reserve strengthening set forth in the regulations is Example (1):

> *Example (1). (i) As of the end of 1985, X, a calendar year taxpayer, had undiscounted unpaid losses of $1,000,000 in the workerscompensation (sic) line of business for the 1984 accident year. The same reserve had undiscounted unpaid losses of $900,000 at the end of 1986. During 1986, X's loss payments for this reserve were $300,000. Accordingly, under paragraph (c)(3)(i) of this section, X has a reserve strengthening of $200,000 ($900,000 - ($1,000,000 - $300,000)).*
>
> *(ii) This was X's only reserve strengthening or weakening.*

From this, the IRS concludes that there was $200,000 of reserve strengthening in 1986.

Example (2) is similar to Example (1), serving to illustrate the effect of the limitation on the amount of reserve strengthening:

> *Example (2). The facts are the same as in Example 1, except that X's 1986 loss payments for the reserve were $1,100,000. If only paragraph (c)(3)(i) of this section were applied, X would have a $1,000,000 reserve strengthening ($900,000 - ($1,000,000 - ($1,100,000)). Under paragraph (c)(1) of this section, however, the amount of reserve strengthening for the reserve is limited to the amount of the reserve at the end of 1986.*

Example (3) is similar to Example (1), but instead illustrates reserve weakening. It concludes with the statement that the only effect of reserve weakening is to reduce the amount that is required to be included in income as a result of strengthening of another reserve.

These numeric examples indicate that the IRS considers *any* addition to previously estimated incurred losses to constitute reserve strengthening, allowing for decreases in some reserves to offset increases in others and subject to the limitation that the amount of reserve strengthening cannot

exceed the amount of remaining reserves for a given accident year.[9]

There is nothing in the language of these examples to indicate that the described re-estimation of the reserves is anything out of the ordinary, normal, and very much anticipated re-estimation process that is an integral part of setting reserves for a PC insurer. In fact, a more specific example could be constructed that would fit all of the criteria of the IRS's Example 1 and that would clearly demonstrate that there had been no change to the adequacy of reserves.

Suppose that: (a) taxpayer X of Example 1 writes only workers compensation insurance and it has unpaid claims from various accident years, including the 1984 accident year, as of year end 1985; (b) X's losses from accident years other than 1984 are perfectly reserved so that for each dollar of loss paid, a dollar of loss is removed from the reserves; (c) the 1984 accident year reserves are case reserves only and do not include a provision for IBNR; and (d) $300,000 was paid during 1986 for an accident year 1984 claim as a result of prior mis-estimation of an outstanding claim that had been carried as an undiscounted case reserve at year end 1985 at $100,000 but which was paid in the amount of $300,000 during 1986; and (e) the remaining $900,000 of undiscounted 1984 accident year case reserves at year end 1985 are unchanged during 1986, and, therefore, at the end of 1986 X's total reserves are $900,000.

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[9] For the remainder of the text, this limitation placed on the amount of reserve strengthening by the IRS is assumed without repetition of the phrase.

The situation described above fits the specifics of Example 1, yet there has been no change in the level of the adequacy of reserves (that is, no reserve strengthening). Accident years other than 1984 were perfectly reserved, so there is no reserve strengthening or weakening. In fact, the remaining accident year 1984 case reserves (which, in this example are identical in the aggregate to the total reserves since there is no IBNR) at year end 1986 are each identical to what had been held at the year end 1985, so there has been no change at all to the remaining case reserves for accident year 1984. What happened is that an unpaid claim that had been under-reserved at year end 1985 was paid during 1986 for $200,000 more than its prior estimated cost. According to the IRS, this $200,000 counts as reserve strengthening when, in fact, this is the result of an actual payment with no other changes to the remaining reserves.

Why the IRS Definition Fails to Describe Reserve Strengthening

In my opinion, the definition put forth by the IRS fails to constitute reserve strengthening because it does not require the presence of all of the four chief characteristics of reserve strengthening set out in Section (3) above.

First, the IRS definition considers any and all increases in estimated pre-1986 accident year ultimate incurred losses to be reserve strengthening, not just increases arising from a one-time or non-periodic change. Exhibit 3 to this report shows how estimated ultimate incurred losses can change as a result of a routine, periodic and very much anticipated re-examination of loss development. The example presented in

Exhibit 3 does not constitute reserve strengthening, but the IRS would consider it as such.

In fact, the decision in the Western National case (102 T.C. 338 (1994)) states that Section 1.846-3(c), Income Tax Regulations dealing with reserve strengthening, is "invalid to the extent that it defines all additions to reserves as reserve strengthening." Another section of that same decision states, "Had Congress used such plain language as 'all additions' and 'all increases,' we would ... attribute the everyday plain meaning to those words." Clearly, the Tax Court understands the same thing that PC actuaries understand: Not all increases to estimated ultimate incurred losses constitute reserve strengthening.

Second, the IRS definition considers any and all increases in estimated ultimate incurred losses to be reserve strengthening without consideration of the material nature of the change in the assumptions and/or methodologies. If an insurer used a loss development factor of 1.100 to estimate ultimate losses from a 60 month valuation point to ultimate, and the next year used a loss development factor of 1.101 for this same period, the IRS would consider this to constitute reserve strengthening, all other things remaining equal. This action does not constitute reserve strengthening because the change in assumptions is not material.

Referring again to Exhibit 3, the IRS would consider this example to be reserve strengthening, even though the methodology has not changed in 1986 from what it was in 1985. The methodology still relies on the average of the most recent three years of development factors to estimate ultimate incurred losses and, hence, reserves. The loss data

have changed and now reflect the emergence of claims over the 1986 calendar period, but the methodology is unchanged.

Third, the IRS definition considers any and all increases in estimated ultimate incurred losses to be reserve strengthening without considering whether the change results in a material change in the level of reserve adequacy. If the estimated ultimate incurred losses for an insurer were $800 million for accident years 1985 and prior as of year-end 1985 and the estimated ultimate incurred losses for accident year 1985 and prior are now $801 million, the IRS would consider this to be reserve strengthening although the change is not material.

This same example also provides an illustration of why the IRS definition fails to satisfy the fourth requirement of reserve strengthening. According to the IRS definition of reserve strengthening, a part-wise increase in the level of reserve adequacy would constitute reserve strengthening although the overall adequacy of the total reserve inventory at the year-end may not have increased. The term "reserve strengthening" refers to a material increase in the relative level of adequacy in a PC insurer's *total inventory* of aggregate reserves from one valuation date to another.

The IRS definition, on the other hand, (1) uses "reserve strengthening" to refer to increases in the estimated ultimate incurred losses rather than increases in the level of adequacy of the total reserves and (2) applies the term in the narrower context of accident year reserves rather than total year-end reserves. For example with reference to year-end 1985 and 1986, reserve strengthening refers to a comparison of the relative adequacy of the aggregate reserves at year-end 1985 for all accident years 1985 and prior with the adequacy of the

aggregate reserves at year-end 1986 for all accident years *1986* and prior.

The IRS, on the other hand, uses the term reserves strengthening in the sense of comparing year-end 1985 estimated ultimate incurred losses for all accident years 1985 and prior with year-end 1986 estimated ultimate incurred losses for all accident year *1985* and prior, thus omitting any reference to the "new" accident year 1986.

The example set out in Example 1 presents a comprehensive illustration of why the IRS definition fails to conform to all of the characteristics of reserve strengthening set out in section (3). For simplicity, assume that this company's claims are paid and closed for all accident years prior to 1983. In this example, total reserves have been set at year-end 1985 at $800 million for accident years 1985 and prior (column 4). If the ultimate incurred losses turn out to be as stated in column 6 rather than what they were estimated to be in column 5, then the reserve should have been $860 million (column 7) at year-end 1985 rather than the $800 established in column 4.[10] In this case, the adequacy of reserves as a ratio of actual reserves to the reserves that should have been held at that time (required reserves) is 0.930 ($800 million divided by $860 million).

[10] The ultimate incurred losses cannot truly be known until all claims have been closed and paid. For this reason, it is difficult at any valuation date to measure slight changes in the level of reserve adequacy because the whole inventory of year-end reserves must be considered. This imputes even greater importance to the concept of reserve strengthening as a material increase rather than simply any increase in the adequacy of reserves.

At the end of 1986, claims for the accident year 1983 are completely closed and paid. The insurer has changed its estimates of what the reserves for the 1984 and 1985 accident year would otherwise have been and now has set them at a level, for each individual accident year, that is different from what they otherwise would have been at year-end 1986. The 1984 reserves at year-end 1986 are now $10 million, but if the prior assumption about the estimated ultimate incurred losses had remained unchanged, the reserves would have been $30 million. The accident year 1985 reserves at year-end 1986 are now $300 million, but if the prior assumption about the estimated ultimate incurred losses had remained unchanged, the reserves would have been $250 million.

The IRS measure of reserve strengthening compares the changes during calendar year 1986 in estimated ultimate incurred losses and, in so doing, considers the aggregate of all changes to pre-1986 accident years. Hence, the IRS would consider this to be a situation where there is reserve strengthening because the estimated ultimate incurred losses for pre-1986 accident years as of year-end 1986 is now $1,760 million, which is $10 million higher than the year-end 1985 estimate for those same accident years.

If one were to consider the correct definition of reserve strengthening, which is one that considers the relative adequacy of the *total* reserves as of year-end 1986, that would show a decrease rather than an increase to the level of overall reserve adequacy. The ratio of the actual reserves to required reserves for all accident years as of year-end 1986 is 0.835 (column 16) compared to 0.930 as of year-end 1985.

This example does not constitute reserve strengthening according to the definition set out in Section (3) and the characteristics described in points (a) through (d) in that section. First, there is no indication from this example that this is a non-periodic or unusual adjustment. In fact, on the surface, the figures for year-end 1986 look much like the result of normal periodic actuarial review of the reserve estimates.

Second, there is no indication that the changes have arisen from a material change in assumptions or methodologies. The IRS does not consider in its definition whether or not such changes have occurred and mechanically calculates the change in the estimated ultimate incurred losses to determine the presence of what it would describe to be reserve strengthening.

Third, the increase in pre-1986 accident year estimated ultimate incurred losses is minimal. Even if one were to accept the IRS part-wise definition of increases in only the pre-1986 accident year estimated ultimate incurred losses as constituting reserve strengthening, a change of 0.6% ($10 million divided by $1,750 million) simply is not material.

Fourth, there has been a decrease to the level of adequacy of the insurer's reserves, rather than an increase so there certainly cannot be any reserve strengthening. At year-end 1985 the reserves could be considered to be "93.0% adequate." At the end of 1986, and accepting for the moment the IRS part-wise definition as applying only to pre-1986 accident years, there is no reserve strengthening because the reserves are "86.1% adequate," a decrease from "93.0% adequate." Using the correct definition of reserve

strengthening as applying to the entire inventory of reserves, the year-end 1986 reserve adequacy has slipped to 83.5%, an even greater decrease in the degree of reserve adequacy.

IRS Definition is Mechanical and Applies in Situations Where There is No Reserve Strengthening

The definition of reserve strengthening used by the IRS is a mechanical arithmetic calculation and in many instances would include situations which do not actually constitute reserve strengthening in the sense that this term is used by PC actuaries with respect to reserves established for Annual Statement purposes.

If an insurer acquired additional information and determined that its initial estimate for total losses for any accident year was too low, and, as a result, increased the unpaid loss reserve for that accident year by an appropriate amount, the IRS would automatically characterize this process as reserve strengthening even though this may not actually be the case.

As a result of the fact that the IRS definition of reserve strengthening does not exhibit the characteristics outlined in the Section (3), application of its definition can lead to a number of nonsensical results. For example, consider an insurer who is chronically under-reserved to the same degree each year. As claims emerge over time, the insurer "catches up" by adding case reserves as the claims become reported, rather than by providing for these cases earlier in the IBNR reserve. This insurer will always be caught in a situation which the IRS considers to be reserve strengthening. The insurer, however, has not changed the methods and assumptions underlying its estimated ultimate incurred losses

and, in fact, has neither changed the general accuracy of this reserve nor improved the degree of adequacy of its reserves.

An extreme example of this phenomenon would be an insurer that estimates zero IBNR and whose total reserves are comprised solely of aggregate case reserves. As each new claim comes in, the insurer establishes a case reserve for it until eventually all claims are reported and paid. As time passes and new accident years are accounted for on the books of the insurer, the reserving practices continue in the same manner. The insurer has done nothing to strengthen reserves. In fact, if the newer accident years have less adequate case reserves than the older accident years, the overall adequacy of the insurer's reserves has declined, but according to the IRS this company would be engaging in reserve strengthening.

In conclusion, the IRS definition of reserve strengthening and the examples in its regulations that are used to demonstrate reserve strengthening in fact fail to describe reserve strengthening as it is understood in the PC insurance business. Primarily it fails because it is a mechanical test

which counts as reserve strengthening any and all increases in estimated ultimate incurred losses for pre-1986 accident years. The IRS definition, in its attempt to delineate the reserve strengthening process, covers too great a territory and captures numerous types of changes which do not constitute reserve strengthening.

/s/ Irene K. Bass

Irene K. Bass
December 9, 1994
1166 Avenue of the Americas
New York, NY 10036-2708

Attached to the report of Irene K. Bass were several tables that have been omitted. They appear in their entirety at page 150 of the parties' joint appendix in the Court of Appeals for the Third Circuit.

IRENE K. BASS, FCAS, FCIA, MAAA

1. Formal Education

Master of Science - 1973 - Northeastern University, Boston, Massachusetts. Major: mathematics

Bachelor of Arts, *magna cum laude* - 1971 - Bowling Green State University, Bowling Green, Ohio. Majors: mathematics and German

2. Professional Designations

Fellow - Casualty Actuarial Society, New York, New York

Fellow - Canadian Institute of Actuaries, Ottawa, Ontario

Member - American Academy of Actuaries, Washington, D.C.

3. Employment History

1990 - Present	Managing Director, William M. Mercer, Incorporated, New York, New York.
1987 - 1990	Principal, William M. Mercer, Incorporated, New York, New York.
1983 - 1987	Senior Vice President, Crum & Forster Insurance Group, Basking Ridge, New Jersey.

1978 - 1983	Actuarial Director, John Hancock Mutual Life Insurance Company, Boston, Massachusetts.
1973 - 1978	Assistant Actuary, Commercial Union Assurance Companies, Boston, Massachusetts.

4. Professional Activities

Casualty Actuarial Society

Offices

President	1993 - 1994
President-elect	1992 - 1993
Vice President, Continuing Education	1989 - 1992
Board of Directors	1986 - 1989 and 1992 - present (Chair, 1994 - present)

Committees

Nominating Committee	1994 - present
Textbook Steering Committee, Chairman	1985 - 1989 Responsibilities included publication of the first CAS textbook, *Foundations of Casualty Actuarial Science*.

Long Range Planning Committee	1986 - 1989 and 1992 - 1993
Program Planning Committee	1983 - 1986
Editorial Committee	1981 - 1983

American Academy of Actuaries

Board of Directors	1992 - 1994
Casualty Practice Council	1992 - 1994
Planning Committee	1992 - 1993
Nominating Committee	1992 - 1993
Task Force on Continuing Education Recognition	1989 - 1991

Casualty Actuaries of Greater New York

President	1987
President-elect	1986
Vice President	1985

Casualty Actuaries of New England

Secretary-Treasurer	1982 - 1983

5. Other Professional Memberships

International Association of Consulting Actuaries
International Actuarial Association (ASTIN and AFIR)

6. Publications

"Surplus Allocation: An Oxymoron?" The Casualty Actuarial Society, Discussion Paper Program, May 1992 (co-author with C.K. Khury).

"The Role of Underwriting and Marketing in Pricing," The Casualty Actuarial Society, *The Forum*, Fall 1988.

"Corporate Planning: An Approach for an Emerging Company," The Casualty Actuarial Society, Discussion Paper Program, May 1985 (co-author with L. Carr).

7. Speeches & Presentations

"Rate of Return and Profitability Issues in California's Proposition 103," Casualty Actuarial Society, Special Interest Seminar on Insurer Profitability, October 1991 and October 1992.

"California Proposition 103 Issues," Casualty Actuarial Society Ratemaking Seminar, 1990.

"The Role of Underwriting and Marketing in Pricing," Casualty Actuarial Society Ratemaking Seminar, 1988 and 1989.

"Personal Lines Classification Plans: Actuarial and Real World Considerations," Casualty Actuarial Society Spring Meeting, May 1987.

"Actuarial Advocacy, an Oxymoron?" Casualty Actuarial Society Annual Meeting, November 1985.

8. Civic Activities

Student/Sponsor Partnership, New York, New York

Sponsor	1989 - 1991

Jersey Battered Women's Service, Inc., Morristown, New Jersey

President	1987
Vice President	1986
Board of Directors	1984 - 1987

IN THE UNITED STATES TAX COURT

Docket No. 25767-93

ATLANTIC MUTUAL INSURANCE COMPANY

AND

INCLUDIBLE SUBSIDIARIES,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

EXPERT OPINION REPORT

Prepared by:

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INDEX

PURPOSE

The purpose of this report is:

(a) to provide an opinion as to whether the test of reserve strengthening used by the IRS in its Regulations accurately measures "reserve strengthening" as that term is used in the insurance industry; and

(b) to provide an opinion as to whether Atlantic Mutual Insurance Company engaged in "reserve strengthening" with respect to its 1986 loss reserves.

BIOGRAPHICAL SUMMARY AND QUALIFICATIONS

EDUCATION: Bachelor of Philosophy, major in Mathematics
Northwestern University, 1963

Professional Degrees and Designations:
Fellow, Casualty Actuarial Society, 1963
Fellow, Society of Actuaries, 1967
Fellow, Conference of Consulting Actuaries, 1977
Member, American Academy of Actuaries, 1965
Member, International Actuarial Association, and its ASTIN and AFIR Sections

From 1988 to 1989, I served as President of the American Academy of Actuaries. From 1980 to 1981, I served as President of the Casualty Actuarial Society. I am also a member of the Board of the International Actuarial Association. I have also served as a Board Member and

Vice-President-Education and Examination of the Society of Actuaries. I have served on many committees and task forces of the various actuarial organizations.

EMPLOYMENT:

I have been employed as an actuary since 1960, when I joined Continental Casualty Company. In 1972 I became a consultant, and have been involved in consulting activities since that time. For two academic years in 1973-1975, I served as Professor of Actuarial Science at the University of Michigan.

As a consultant I have provided actuarial services to a wide variety of clients, including insurance companies, regulatory officials, buyers of insurance, legislators, investors, and trade associations.

Currently I am the National Director of Actuarial Services of Ernst & Young LLP. As such I am responsible for approximately one hundred professionals. Our services are provided to insurance companies, regulators, buyers of insurance, and a variety of self-insurance mechanisms. Prior to joining Ernst & Young LLP, I worked for nearly 20 years at Tillinghast, where I led the casualty actuarial practice.

In 1985 I provided some services to the General Accounting Office in conjunction with their study of the taxation of property-casualty insurance companies. That study was one of the items available to the Congress in the enactment of the Tax Reform Act of 1986.

SOURCE OF INFORMATION

In conjunction with this case I have reviewed the statutory annual statements filed by Atlantic Mutual Insurance Company for 1985, 1986 and 1993, among others. I have also reviewed the calculations of so-called reserve strengthening by the IRS. I visited the offices of Atlantic Mutual Insurance Company on December 7, 1994, and interviewed personnel involved in the establishment of reserves for losses and loss adjustment expenses, as well as reviewing documents related to the reserves for December 1985 and December 1986. In addition I reviewed actuarial, accounting and financial analysts literature concerned with insurance company reserves.

I have reviewed the report prepared by Irene Bass, dated December, 1994, and am in agreement with it. This report will explain in detail only the essential characteristic of reserve strengthening relating to the level of reserve adequacy. Although the other essential characteristics of reserve strengthening identified in the report prepared by Irene Bass are not discussed or explained in this report, such characteristics also must be satisfied for reserve strengthening to be present.

CONCLUSION

On the basis of my analysis, discussed below, my conclusions are that:

1. The IRS test does not measure reserve strengthening as that term is understood by actuaries or by

those responsible for setting loss reserves reported on the Annual Statement; and

2. Atlantic Mutual did not strengthen reserves in 1986; rather, its already inadequate reserves became more inadequate.

ANALYSIS

Reserving

Insurance companies issue policies that promise to pay future claims if specified contingencies occur, within the policy period, such as fire or accidental injury. It may take several years to finally settle a claim. An injured worker, for example, may be entitled to disability payments and medical expenses for many years after the accident which produced his injury. In order to meet its objections under the policy, the insurance company carries a liability on its balance sheet for future payments on claims where the incident giving rise to the claim has already occurred. This liability is commonly referred to as a reserve, or a reserve for losses. There is also a similar liability for the expenses associated with claims, commonly referred to as the reserve for loss adjustment expense (LAE).

Since these reserves are so important to the sound operation of an insurer, they are subject to regulatory review. Indeed, these reserves are one most the most important items in the statement filed each year with the state regulatory authorities who have responsibility for the financial soundness of the insurers licensed in their jurisdiction. Known as the Statutory Annual Statement, this report

contains several schedules which provide extensive information about the reserves held by the company. It also contains substantial information about the adequacy of reserves held in prior years, as evaluated with the benefit of hindsight.

The exact amount of the future payments that an insurer will be called upon to make, on account of incidents that have already taken place, cannot be known with certainty. This is because the amount of payment is dependent on future contingent events. Examples of such events would include:

A. Recovery, death, or continued disability of an insured person;

B. Advances in medical practice that increase (decrease) the cost of treatment for a particular condition;

C. Decision by a potential plaintiff to bring suit;

D. Decision of a judge or jury about negligence and about the amount of damages;

E. Changes in structure and level of fees.

Casualty insurers use a wide variety of methods to estimate the value of their liability for future claim payments. Virtually all commercial insurers, however, base the process, in substantial part, on the estimates that are made on individual claim files by their claim examiners. This is particularly true for larger, longer to settle, and more difficult claims. These estimates by the examiners are based on their

experience with similar claims, which means that they are based on the individual facts and circumstances of the particular claim.

Insurers understand that not all claims will have been reported by any financial statement date. Consequently, they accrue a reserve liability for claims that have been incurred but not reported (IBNR). For some coverages, they also expect that the ultimate cost of settlements may exceed the total of the estimates as of any specific financial statement date. Consequently they may also accrue a reserve liability for adverse development. This can be part of the IBNR reserve (incurred but not enough reported) or can be separate.

Reserve Strengthening

Property-casualty loss reserves are often referred to as strong or weak in a manner that is synonymous with adequate or inadequate. This means that they are adequate or inadequate to discharge the obligations of the insurer for claims arising from incidents that have already taken place as of the date of the financial statement. In one sense this adequacy can only be tested in retrospect, after all the claims have been settled (and the prospect of an old claim reopening is sufficiently remote).

But reserves are required for current financial statement; it is not possible to keep the books open until the last claim is closed. Consequently they are estimated using currently available information and techniques. However, the only statement that can definitively be made about a current reserves adequacy is in relation to another value for the *same reserve* at the *same point in time*: the larger reserve

is more adequate, or stronger. To compare the adequacy, or strength, of a current reserve for a line of business to the adequacy, or strength, of a previous reserve for that same line of business required judgment, or estimation, until some future time when the claims covered by both reserves have all been finally settled. Then, and only then, can a definitive statement about the relative adequacy, or strength, of the two reserves be made. Until that time there is always some change that future settlements will affect the retrospectively determined adequacy, or strength, of one of the reserves but not the other. This is because the later reserve covers claims arising from incidents that were not covered by earlier reserve.

An example may help to clarify this. Suppose we wish to compare the adequacy of reserves for the same company and line of business at the end of year 1 and the end of year 2. The reserve at the end of year 1 covers unsettled claims arising from incidents occurring in year 1. The reserves at the end of year 2 cover both unsettled claims arising from incidents occurring in year 2 *and* any remaining claims from year 1 that are still unsettled at the end of year 2. Settlements of year 1 claims which occur after the end of year 2 will affect the retrospective determination of adequacy of both the year 1 reserve and the year 2 reserve. But settlements after year 2 of year 2 claims will affect the retrospective determination of adequacy of only the year 2 reserve. So if, in year 4, a claim for year 1 is settled for ten times its previously estimated and reserved amount, then both the reserve at the end of year 1 and the reserve at the year of year 2 will look, in retrospect, to have been more inadequate (or less adequate) than they did before the settlement. If however, the ten times settlement were for a

year 2 claim, then only the retrospective evaluation of the adequacy of the reserve at the end of year 2 will be impacted.

There is an exception to this observation about the difficulty of comparing adequacy of reserves at separate points in time. If the reserves at the two points in time cover the same set of claims, then a comparison of relative adequacy, or strength, can be made. So if, in the preceding example, the reserve at the end of year 2 covers only claims arising from incidents in year 1, then the comparison can be made. Since payments and settlements have been made in the interim, however, the comparison becomes not only one of reserve strength, or adequacy, but one of incurred losses.

Again, and example may help. If claims from year 1 generate payments of $500 in year 1, $1,000 in year 2, and $800 in year 3 (and there are no further payments) and if the reserve at the end of year 1 for these claims is $1,500, and at the end of year 2 is $1,000, then the reserve at the end of year 1 was inadequate, or weak, because it did not cover the $1,800 of future payments ($1,000 in year 2 and $800 in year 3). The reserve at the end of year 2, however, was adequate (even redundant) or strong, because it exceeded the $800 amount subsequently paid. Thus we can observe, in retrospect, that the reserve at the end of year 2 was more adequate, or stronger, than the reserve at the end of year 1. It is also possible to make this observation at the end of year 2, before the payments in year 3. How? It cannot be observed by comparing the two reserves, because the $1,000 at the end of year 2 is less than the $1,500 at the end of year 1. But it can be observed by comparing the amount of incurred losses for year 1, measured at the end of year 1, of $2,000 ($500 paid and $1,500 reserved) with the amount of incurred

losses, measured at the end of year 2, of $2,500 ($500 + $1,000 paid, and $1,000 reserved). Since the $2,500 (is greater than the $2,000, it is stronger, and the estimate of incurred losses can be said to have been strengthened by $500.

But note that we have excluded from this example the claims arising from incidents occurring in year 2. This was necessary in order to make any observation about the relative adequacy, or strength, of the two reserve amounts at different points in time. If the year 2 claims had been identical to the year 1 claims, but if the reserve for year 2 claims at the end of year 2 had been only $500, the total reserve at the end of year 2 would have been less adequate than was the total reserve at the end of year 1. This is because the $500 of strengthening in respect of year 1 claims was more than offset by the weakening in respect of year 2 claims. (The reserve for year 2 claims at the end of year 2 is inadequate by $1,300, representing $1,000 + $800 of future payments less the $500 reserve.)

Thus in order to compare the adequacy, or strength, of reserves for a line of business at two points in time, it is necessary to have an estimate of the ultimate settlement value of the claims covered by the later reserves that are not covered by the earlier reserve; these are the claims arising from incidents that occurred between the two dates. While many claims remain open, there will necessarily be some uncertainty in the estimate of adequacy, or strength. The passage of time, and the settlement of claims, will reduce that uncertainty and improve the quality of the estimate, so long as new claims are not being added.

The IRS test of strengthening, as prescribed by Regs. sec. 1.846-3(c)(3), concentrates on developments during 1986 of the amount of losses incurred during 1985 and prior. As such, it can only make a meaningful statement about the change in adequacy of the reserve for 1985 and prior claims. It does not make any estimate of the adequacy or inadequacy, strength or weakness, of the reserve at the end of 1986 in respect of claims arising from incidents in 1986. As such, it makes an incomplete comparison, and since it makes no statement about a major portion of the reserve at the end of 1986, it makes no meaningful statement about the adequacy, or strength, of the reserve at the end of 1986.

The IRS test of strengthening, as prescribed by Regs. sec. 1.846-3(c)(2), does make a weak and inadequate attempt to evaluate the adequacy of the reserves for 1986 accidents, as of the end of the year. It does this by comparing the reserve actually established for 1986 to a hypothetical reserve, using the same assumptions that were used to determine the 1985 accident year reserves. (The regulation does not specify the reserve date from which these assumptions are to be extracted.) In Atlantic Mutual's case, there was every reason to expect that these "same assumptions" would produce inadequate reserves, because they had produced inadequate reserves in previous years. Yet the IRS test, as actually applied, implicitly assumed that this portion of the reserve was exactly adequate. In fact, it has proven to be inadequate, and there was no reason at the time to believe that it was adequate since it was developed using consistent methods and assumptions to those used in prior years, which methods and assumptions had historically produced inadequate reserves.

1986 Versus 1985 and Prior

The IRS test artificially divides the 12/86 reserves into two groupings: 1986 Accident Year (AY) reserves, and 1985 and Prior AY reserves. It thereby ignores the possibility that any increase in the adequacy of the 1985 and Prior AY reserves may be offset by an inadequacy in the 1986 AY reserves. This possibility actually occurs quite frequently in the insurance business. It is particularly common where a company calculates its IBNR, as does Atlantic Mutual, by an historical review of the number and average cost of previously unreported losses, rather than by projecting ultimate incurred losses then subtracting reported losses to calculate the IBNR.

Our analysis indicates that whatever increase in adequacy (decrease in inadequacy), of ultimate incurred losses was accomplished by Atlantic Mutual in 1986 with respect to 1985 and Prior accident years, was more than offset by a greater inadequacy in the 1986 accident year reserves established at the end of 1986.

Answer Depends on Data Arrangement

The answer found by the IRS test is a function of the arrangement of the data. The test uses data by line and by accident year, and tests for change in projected ultimate value for each cell. However, accident years 1976 and earlier are grouped together. Losses and loss adjustment expense are also grouped together. While both groupings are consistent with some of the supporting schedules in the Statutory Annual Statement, both are also arbitrary. It would be easy to extend the analysis by year to the earliest year with

an open claim (1952 in Atlantic Mutual's case). It would be easy to test losses and loss adjustment expense separately. Other data arrangements, such as by state, are also possible.

If a different data arrangement were utilized, the amount of reserve strengthening detected by the IRS test would be different. This is because of the arbitrary "inside limits" in the test, where payments greater than the opening reserves are ignored, and where "strengthening" is limited to the ending reserve. In general, the finer the data arrangement and the greater the number of cells, the smaller the amount of "reserve strengthening" that will be calculated by the IRS mechanical test. (See also Example 1, below.)

I have constructed several EXAMPLES to illustrate some of the defects of the IRS test:

Example 1 shows that the amount of reserve "strengthening" depends on whether claims are reviewed separately or in a group; the more finely the data are arranged, the smaller the amount of "strengthening."

Example 2 shows that the "strengthening" detected by the IRS test is arbitrary because it depends on when a claim is settled.

Example 3 shows that external events, beyond the insurer's control, can produce "strengthening" under the IRS test.

Example 4 shows an anomaly in the IRS test that consistently under reserved insurers will always manifest "strengthening" while consistently over reserved insurers

will not and could actually be increasing reserve adequacy without detection).

Example 5 illustrates how reserve "strengthening" can be found by the IRS test when there has been no change in practice, and a probable weakening has occurred.

All of these examples help to illustrate that, whatever the IRS test is measuring, it is not reserve strengthening.

CONCLUSION 1

As a result of my analysis described above, I conclude that:

(a) the IRS test prescribed by Regs. sec. 1.846-3(c)(3) does not even attempt to measure reserve strengthening, principally because it ignores the 1986 accident year, and the test of the adequacy of the 1986 accident year prescribed by Regs. sec. 1.846-3(c)(2) uses a faulty test which presumes adequacy even in the face of historic evidence to the contrary;

(b) while it purports to measure the change in the projection of ultimate incurred losses for accident years 1985 and prior that occurred during 1986, it fails to do so accurately, principally because it imposes artificial and arbitrary limits on payments in excess of opening reserves and on strengthening in excess of ending reserves; and

(c) the amount of so-called reserve strengthening detected by the IRS test will vary, perhaps significantly,

depending on the arbitrary data arrangements used in the analysis, because of the limits in (b) above.

Atlantic Mutual

Atlantic Mutual is a multi-line insurance company, writing primarily workers' compensation and commercial multi-peril insurance. Atlantic Mutual has been run by a stable management team in the same way for many years.
It has also set its reserves in a consistent manner for many years. In particular, it established its reserves as of year-end 1985 and 1986 in a consistent manner.

Case Reserves

The majority of Atlantic Mutual reserves for unpaid losses in 1985 and 1986 were case reserves. These case reserves are set on a case by case basis, based on the individual facts and circumstances of each claim. The amount of these individual case reserves was $255.7 million at 12/85 and $277.7 million at 12/86.

IBNR Reserves

In addition to these case reserves, Atlantic Mutual established a bulk reserve to cover claims that had been incurred but had not yet been reported (IBNR). This IBNR was $93.7 million at 12/85 and $111.7 million at 12/86. As such, it was approximately 29% of the total reserve held for unpaid losses.

Atlantic Mutual did increase its IBNR reserves in 1986, from $93.7 million to $111.7 million. This was done

in response to significant premium growth, as shown in the following table:

1985

Line	*Net Premium Earned ($000's)*	*12/31 ($000's)*	*IBNR %*
Auto Liability	65,571	16,720	25.5
General Liability	8,457	15,945	188.5
Workers' Comp	37,261	10,339	27.7
Multiple Peril, etc.	139,569	43,622	31.3
Other Lines	58,347	7,087	12.1
Total All Lines	309,205	93,713	30.3

1986

Line	*Net Premium Earned ($000's)*	*12/31 ($000's)*	*IBNR %*
Auto Liability	84,243	21,052	25.0
General Liability	13,659	14,636	107.2
Workers' Comp	49,642	14,362	28.9
Multiple Peril, etc.	187,675	52,740	28.1
Other Lines	73,081	8,918	12.2
Total All Lines	408,300	111,708	27.4

Atlantic Mutual developed its IBNR reserves by projecting the number of unreported claims for each line of business, and then estimating the average amount of these claims. The total IBNR reserves that were indicated for each line of business were further evaluated by quarterly actuarial reviews of the previous year's reserves, based on which senior management would judgmentally increase or decrease the amount of IBNR actually held. In some cases, the adjustment amounts were intended to correct perceived underestimates or overestimates of case reserves in a particular line of business. This methodology and practice was consistent with what was done to establish Atlantic Mutual's IBNR reserves for each of the 1984 and 1985 years.

The above table shows that the growth of IBNR reserves, while substantial, failed to keep pace with premium growth. Retrospectively, we know that Atlantic Mutual actually lost reserve adequacy in 1986, in spite of the substantial increase in the absolute amount of the IBNR reserves.

LAE Reserves

In 1985 and 1986 Atlantic Mutual determined its loss expense reserves partly by individual case estimate, partly by formula, and partly by judgmental factors.

Individual case estimates were established for anticipated legal expenses associated with known claims that were in litigation as of December 31, 1985 and 1986.

Formula ALAE reserves were established via the application of historically determined ALAE to loss ratios to currently held loss case reserves and loss IBNR. Judgmental additions to the overall formula ALAE reserves were made on the basis of additional quarterly analyses that developed ratios of ultimate paid ALAE to ultimate paid loss, which were then applied to projected ultimate losses. Formula ULAE reserves were established via the application of a historically determined paid expense to loss ratio applied to case and IBNR reserves.

Atlantic Mutual also increased its LAE reserves in 1986, from $72.3 to $84.1 million. They did this in response to significant premium growth, and to indications that past LAE reserves had not been adequate, as shown in the following table:

1985

Line	*Net Premium Earned (000's)*	*12/31 (000's)*	*LAE %*
Auto Liability	65,571	8,593	13.1
General Liability	8,457	13,636	161.2
Workers' Comp	37,261	6,137	16.5
Multiple Peril, etc.	139,569	43,044	30.8
Other Lines	58,347	907	1.6
Total All Lines	309,205	72,317	23.4

1986

Line	*Net Premium Earned (000's)*	*12/31 (000's)*	*LAE %*
Auto Liability	84,243	9,544	11.3
General Liability	13,659	13,066	95.7
Workers' Comp	49,642	6,885	13.9
Multiple Peril, etc.	187,675	53,397	28.5
Other Lines	73,081	1,175	1.6
Total All Lines	408,300	84,067	20.6

The above table shows that the growth of LAE reserves, while substantial, failed to keep pace with premium growth. Retrospectively, we know that Atlantic Mutual actually lost reserve adequacy in 1986, in spite of the substantial increase in the absolute amount of the LAE reserves.

While Atlantic Mutual officers believe they used consistent methods to calculate their 1986 AY reserve, there is objective evidence that they failed to keep pace with the growth in business. As a result, the weakness of the reserve held on 12/86 for the 1986 accident year more than offset any increase in the strength of the reserves held for the 1985 and prior accident years. By ignoring the weakness of the 1986 accident year reserves, and concentrating on only the 1985 and prior accident year portion of the reserves, the IRS has found "strengthening" when in fact the reserves were less adequate.

At the end of 1985, Atlantic Mutual had a total reserve for loss and loss adjustment expense of $421.7 million. In the ensuing eight years, it has paid $449.7 million on claims from 1985 and prior accident years. As of December 1993 it has reserves for additional payments, of $56.5 million, as follows:

Reserve for losses on known cases	$38.7 million
Reserve for IBNR losses	8.1 million
Reserve for ALAE on known cases	3.8 million
Reserve for IBNR ALAE	3.6 million
Reserve for ULAE	2.4 million

It is reasonable to assume that the $56.5 million is accurate and that future development will be small. With that assumption, the indicated deficiency in the December 1985 reserve is $84.6 million.

At the end of 1986, Atlantic Mutual had a total reserve for loss and loss adjustment expense of $473.5 million. In the ensuing seven years, it has paid $491.1 million on claims from 1986 and prior accident years. As of December 1993 it has reserves for additional payments, of $71.2 million, as follows:

Reserve for losses on known cases	$47.0 million
Reserve for IBNR losses	11.2 million
Reserve for ALAE on known cases	4.2 million
Reserve for IBNR ALAE	5.8 million
Reserve for outstanding ULAE	3.0 million

Assuming the $71.2 million for future payments is accurate, the indicated deficiency in the December 1986 reserves is $88.8 million.

The deficiency in Atlantic Mutual's reserves then, grew by $4.2 million, from $84.6 million to $88.8 million during 1986.

(Because of the uncertainty surrounding liabilities for environmental impairment, there is some chance that future payments will exceed current reserves on very old accident years, i.e., prior to 1985. This would increase the inadequacy of both the December, 1985 and the December, 1986 reserves, by identical amounts. The conclusion that Atlantic Mutual's inadequacy grew during 1986 would remain unchanged.)

CONCLUSION 2

As a result of my analysis described above, I conclude that Atlantic Mutual did not strengthen reserves during 1986 by $6,532,000, or a discounted amount of $1,339,000, as stated by the IRS. Atlantic Mutual did nothing to artificially increase the adequacy of its reserves in 1986. The reserves were inadequate at the end of both 1985 and 1986. Because of a substantial growth in business, the inadequacy of Atlantic Mutual's reserves actually increased in 1986; i.e., they were "weakened," not strengthened, by $4.2 million.

Example 1. Accident Year 1985 has only two claims open at the beginning of 1986, each with a reserve of $50,000. During 1986, the first claim is settled for $75,000 leaving a reserve of $0 at the end of 1996. There is no activity on Claim 2 during 1986; the reserve remains at $50,000. According to the IRS definition of reserve strengthening, there has been no reserve strengthening on either of these claims when examined separately; however, when looked at in total there has been a reserve strengthening of $25,000. (The reason there is no strengthening on the first claim is because strengthening cannot exceed the ending reserve.)

Accident Year 1985

	1985 Reserve	*1986 Paid*	*1986 Reserve*	*IRS Reserve Strengthening*
Claim 1	$ 50,000	$75,000	$ 0	$ 0
Claim 2	50,000	0	50,000	0
Total	100,000	75,000	50,000	0
Claims 1 & 2	100,000	75,000	50,000	25,000

Example 2. This example illustrates how two identical claims show different reserve strengthening amounts depending on when the claim is settled. The claims each had initial reserves of $1,000,000. Claim 1 was settled during 1986 for $2,000,000. Because these claims were from identical occurrences, the company expects to settle the second claim for $2,000,000 as well. However, only $500,000 has been paid by the end of 12/31/86. The remaining $1,500,000 reserve is treated as reserve strengthening. (Note also that the amount of reserve strengthening calculated by the IRS depends on the amount paid in 1986. If the Case 2 claim had paid $1,000,000 during 1986 and had a remaining reserve of $1,000,000, then the reserve strengthening would be $1,000,000 (limited by the amount of the final reserve). If it had paid $1,500,000 and had a remaining reserve of $500,000, then the reserve strengthening would be $500,000.) The IRS calculation of reserve strengthening is a confused mixture of two concepts: One is that reserve strengthening is a function of the estimated ultimate amount of losses incurred for a given line and accident year, whether paid or reserved, and the other is that reserve strengthening is a function of the ending reserve.

Accident Year 1985

	Reserve 12/31/85	Payment during 1986	Reserve 12/31/86	Reserve Strengthening during 1986
Case 1	$1,000,000	$2,000,000	$ 0	$ 0
Case 2	$1,000,000	$ 500,000	$1,500,000	$1,500,000

Example 3. Consider the case of a reinsurer that became insolvent in 1986. The primary company had ceded reserves of $10,000,000 to the reinsurer as of 12/31/85. During 1986, the reinsurer became insolvent, leaving the primary company to involuntarily accept the burden and to add this additional amount to its current reserves. We have assumed that no payments were made during 1986 for ease of explanation. The IRS definition would produce reserve strengthening of $10,000,000, penalizing the primary company for an event completely out of its control!

All Accident Years
Reinsurer becomes insolvent during 1986

(1) Direct + Assumed Reserves @ 12/31/85	$75,000,000
(2) Ceded Reserves @ 12/31/85	10,000,000
(3) Net Reserves @ 12/31/85 [(1) - (2)]	$65,000,000
(4) Payments in 1986 on Direct + Assumed Reserves	$ 0
(5) Payments in 1986 on Ceded Reserves	0
(6) Direct + Assumed Reserves @ 12/31/86	$75,000,000
(7) Ceded Reserves @ 12/31/86	0
(8) Net Reserves @12/31/86 [(6) - (7)]	$75,000,000
(9) Reserve Strengthening as per IRS Definition	$10,000,000

Example 4. Companies A and B are identical except for their reserving. Both have exposures that result in two claims each year, for $500 each. One of the claims is settled in the year after the loss, and the other in the second year after the loss. Company A (over) reserves all claims for $1,000, while Company B (under) reserves all claims for $250. The IRS test for 1985 and prior years will find reserve strengthening in Company B but not in Company A. In fact, neither company has strengthened or weakened reserves.

	AY	*Company A*	*Company B*
12/85 Reserve	84	$1,000	$ 250
	85	2,000	500
1986 Payments	84	500	500
	85	500	500
12/86 Reserve	85	1,000	250
	86	2,000	500
IRS Test	Paid	1,000	1,000
	Reserve Change	(2,000)	(500)
	Strengthening	(1,000)	250

The strengthening detected by the IRS test is only $250 for Company B, because the amount of strengthening is limited to the ending reserve for each accident year. The actual amount by which the ultimate incurred for accident years 1985 and prior has been increased, or strengthened, is $500.

The IRS will assume the 1986 reserve is exactly adequate, when in fact Company A is overreserved and Company B is underreserved.

REPORT

ON "RESERVE STRENGTHENING"

ATLANTIC MUTUAL INSURANCE COMPANY

MUTUAL INSURANCE COMPANY AND INCLUDIBLE

SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE,

TAX COURT NO. 25767-93

Prepared by:
Raymond S. Nichols, F.C.A.S., M.A.A.A.
December 14, 1994

RESPONDENT'S EXHIBIT AE
DOCKET NO. 25767-93

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EXECUTIVE SUMMARY

The purpose of this report is to opine on the meaning of "reserve strengthening" as this term is used in the property casualty ("p/c") industry and as I would apply it this term to Atlantic Mutual. In the property-casualty industry the term "reserve strengthening" has various meanings, rather than a single universal meaning. However, in determining a property-casualty insurer's underwriting income, "reserve strengthening" generally refers to a positive amount resulting from the difference between calendar year incurred losses and accident year incurred losses.

"Reserve strengthening" may refer simply to net additions to prior year aggregate reserves. This definition will be referred to as the "management definition" throughout this report. Even with this less technical definition, however, "reserve strengthening" usually refers to an impact on underwriting income. The first definition of "reserve strengthening", given in the paragraph above, includes the less technical management definition of net additions to prior year end aggregate reserves.

"Reserve strengthening" may mean increased reserves on individual claim files for known but not settled claims. This third definition is common within claim departments or among managers discussing claim department operations. Actuaries and accountants know that such increases must be offset by complementary decreases in actuarial reserves before these increases can have financial impact. This third definition will be called the "adjusters' definition" for purposes of this report. The first definition

includes the situation where individual claims reserves are increased, but not offset by decreases in actuarial reserves.

A fourth definition of "reserves strengthening" may be that of positive additions to prior year aggregate reserves when these additions result from a change in the assumptions and methods used to quantify reserves. This is a restrictive definition and would apply only in limited situations. Throughout the rest of this report this fourth definition will be referred to as the "restrictive definition."

Casualty actuaries study a common body of professional literature. Because of their common body of knowledge, they are familiar with the definition of "reserve strengthening" given by the formula:

Year Ending Reserves for Prior Accident Years -
Year Beginning Reserves +
Losses Paid During the Calendar Year for Prior
Accident Years =
Reserve strengthening (weakening).

For example, suppose at December 31, 1994 an insurer's aggregate reserve for claims occurring on or before December 31, 1993 is $500,000. Further, suppose the reserve for the same claims was $1,000,000 at December 31, 1993 with $700,000 paid on these claims during the intervening year. Then "reserve strengthening" during 1994 is $200,000 ($200,000 = $500,000 - $1,000,000 + $700,000.)

Underwriting income in the property-casualty industry changes cyclically. With underwriting cycles, "reserve strengthening" is often systematic and industry

wide. Any definition of "reserve strengthening" that restricts the words to the idiosyncrasies of individual company reserve assumptions and methods will miss the impact of reserve strengthening during underwriting cycles. For this reason alone, the common definition of "reserve strengthening" does not restrict the meaning to changes in reserve assumptions and methods.

There is another reason the restrictive definition of "reserve strengthening" does not encompass the common actuarial use of the words. In practice, good reserving procedures normally entail using more than one set of assumptions and methods. Using "reserve strengthening" as defined by this report always provides an objectively measurable value. With multiple methods and assumptions, the impact of a change in assumptions and methods may not be measurable.

Finally, this report distinguishes the terms "reserve strengthening" and "reserve adequacy." Reserves adequacy affects the measurement of the financial position of an insurer at a point in time. Reserve strengthening affect the matching of revenue and expenses of an insurer during an accounting cycle. The concepts are related but distinguishable. With this distinction, the IRS regulation, Reg. 1.846-3(c)(3), becomes clearer and becomes a measurement of "reserve strengthening." It becomes synonymous with "reserve strengthening" as used in the p/c insurance industry to analyze underwriting income.

BACKGROUND

The term "reserve strengthening" has several meanings in the p/c insurance industry. This is because "loss reserving," or estimating loss and loss expense liabilities, is a central actuarial process that affects three major financial tasks within the industry. P/C actuaries, working on the tasks of ratemaking, reserving, and product pricing are all concerned with estimating loss and loss expense liabilities. At times the differences in these tasks promote differences in how professionals use terms related to loss reserving. Even so, the term "reserve strengthening" is most often used to describe the effect of reserve changes on underwriting income.

In the property-casualty insurance industry, "loss reserving" is the name of the process for estimating liabilities for loss and loss adjustment expenses. Loss reserving is the most difficult part of three critical evaluations: determining the financial position of an insurer, determining the cost of insurance products, and determining the net income of an insurer. Other parts of these evaluations rely on accounting records of transactions that have taken place. In loss reserving, p/c actuaries forecast the financial impacts of events that will take place in the future.

The accuracy of the estimates of loss and loss adjustment expense liabilities has a fundamental impact on the financial strength and stability of an insurance carrier. This impact goes to the heart of what an insurer sells to its customers, the promise to settle claims. In order to make its promises to settle claims, an insurer must estimate the dollar costs that it will incur in fulfilling these promises.

Estimating costs breaks down into two separate, but related tasks. The first task is estimating the premiums needed to fund future promises. P/C actuaries call this task "ratemaking." The second task is estimating the liabilities for promises already made and not yet satisfied. P/C actuaries call this second task "loss reserving." The estimates of loss and loss adjustment expense liabilities are known as the "loss reserves."

Loss and loss adjustment expense liabilities are the largest liabilities of an insurer. The size of these liabilities gives loss reserving its relative importance. Like many forecasting problems, estimating loss and loss expense liabilities is not an exact science. A small percentage error in the estimation can have a large impact on the actions and options of an insurance organization.

The need for accurate estimates is clear in three areas. First, the insurer sells a promise that it will pay for losses and loss adjustment expense. It can keep this promise only if it is now (and continues to be) financially sound. An insurer must have accurate estimates of its loss and loss adjustment liabilities because, without accurate estimates, the balance sheet will not represent a fair statement of financial position.

A second reason accurate estimates are needed is to price insurance products adequately. Insurance depends on the law of large numbers. The loss of an individual policyholder is not predictable, but the losses from a group of policyholders may be predictable within acceptable ranges. The insurer depends on the results from past groups of policyholders to predict the future results. These results include losses paid and loss liabilities outstanding. Without

accurate estimates of the outstanding liabilities, an insurer's predictions of future results may be flawed.

A third reason estimating liabilities is important is that an insurer needs accurate estimates to monitor its underwriting income and its return on equity. A group of policyholders may have predictable losses within reasonable ranges, but these losses cannot be known exactly. To provide for the uncertainty of the group's losses, an insurer must have a net worth large enough to absorb these fluctuating results. As in any business, the owners of the capital must be able to monitor and match the expense of doing business with the revenues earned. They can only measure the cost of doing business if their loss reserves are accurately estimated and assigned to the proper time period.

It is hard to achieve accurate, stable estimates of loss liabilities because of the structure of these liabilities. An insurance carrier incurs a liability as soon as an insured incident occurs. However, it takes time to discover, report, and settle claims. The need to establish loss and loss adjustment liabilities and the complex structure of these liabilities arises because it takes time and effort to adjust claims.

DISCUSSION AND ANALYSIS

Terms related to loss reserving, such as "reserve strengthening," are used in determining an insurer's financial position, determining the cost of the insurance products, and determining the net income earned in providing these products. P/C actuaries (more commonly known as "casualty actuaries") are the key professionals concerned in all of these

areas of loss reserving. Their use of "reserve strengthening" would determine the meaning of these words for other insurance professionals. For p/c actuaries, "reserve strengthening" usually denotes the impact of reserve changes on underwriting income. Because of their training, all p/c actuaries would understand this impact and would understand the use of "reserve strengthening" in this context.

A P/C ACTUARY'S PROFESSIONAL DEVELOPMENT

The p/c insurance industry developed key professionals, known as p/c actuaries, to serve its particular technical needs. A p/c actuary may design, price and market new products; may establishing reserves for future claims; and may monitor and measure financial results. Broad education and training in all aspects of the p/c insurance business are needed to handle these responsibilities. The necessary knowledge is acquired both through on-the-job training and through extensive individual study.

It takes between four and eight years to attain full professional qualifications as a p/c actuary. Most candidates get their initial training in large insurance companies, consulting firms or insurance rating bureaus. During their training period, candidates will often rotate from one area of responsibility to another, becoming familiar with all phases of actuarial work. Besides their practical work experience, candidates study for the 10 examinations that they must pass to become a Fellows of the Casualty Actuarial Society, or "FCAS."

A P-C ACTUARY'S TRAINING IN LOSS RESERVING

A candidate's understanding of the words "loss reserving" and "reserve strengthening" will be a combination of the candidate's experience with his employer and the use of words in study material from the Casualty Actuarial Society ("CAS"). In different locales and at different times, the words "reserve strengthening" will be discussed in terms of product pricing, financial position, or underwriting income. Also, the history and culture of an individual company may give the words "reserve strengthening" a meaning not common to other companies. Even so, all accredited p/c actuaries study a common body of material and would understand professional literature that discussed this topic.

Among casualty actuaries, their common core of professional knowledge is centered on the CAS's "Syllabus of Examination." The Casualty Actuarial Society conducts an educational and examination program for prospective members in order to develop qualified professionals in the field of casualty actuarial practice. The examination parts in ratemaking indirectly include material on estimating loss liabilities, however, Part Seven is the primary examination on loss reserving. Part Seven outlines the material an actuarial student must know concerning premiums accounting, loss and expense reserves, expense analysis, financial reporting and published financial information. The examination process is rigorous. Every Fellow of the Casualty Actuarial Society has completed this examination process and is familiar with the material on the Syllabus.

Every successful Part Seven candidate is familiar with the examination articles that explain the impact of changes in reserve on net underwriting income. For example, the article "Effect of Loss Reserve Margins in Calendar Year Results" by Rafal J. Balcarek, published in the Proceeding of the Casualty Actuarial Society ("PCAS"), has been on the Syllabus for at least the period 1977 to 1994. In that article, Mr. Balcarek says:

> The amount of benefit or penalty to the calendar year results due to loss reserve margins will be determined by two things:
>
> (1) Adequacy of reserves on losses incurred during the current year.
>
> (2) Development of prior years' losses during the current year.[1]

Later in the article:

> A question remains whether insurance companies use their reserve margins to stabilize their results. The writer realizes that many people regard with horror the idea that one should adjust reserve margins according to the size of the loss ratio. Yet emotions are a poor basis for making sound business judgments. Looking at the matter from a logical point of view, there does not seem to be anything

[1] Balcarek, Rafal J., "Effect of Loss Reserve Margins in Calendar Year Results," *Proceedings of the Casualty Actuarial Society,* Volume LIII (1966), page 2.

> objectionable in increasing reserve safety margins during years of good underwriting results. Conversely, there should be no objections to reduction of these margins in time of poor experience in order to soften its impact, as long as the loss reserves are fully adequate and the company has a sufficient amount of surplus for the type and amount of business it conducts.[2]

Mr. Balcarek concludes his article by saying:

> The main conclusion is that loss reserve margins for the major casualty lines are basically unstable and exert an appreciable influence on calendar year results. In the comparison of the experience of an individual company for one year with that of prior years, or with the experience of other companies, the changes in reserve margins may, on occasion, be the most important single factor responsible for the observed differences.
>
> There is evidence that in the case of an individual company loss reserve margins . . . have a tendency to move in the same direction at the same time. In addition there is also evidence that the companies tend to go together in raising or lowering their loss reserve margins.
>
> The companies do not appear to enjoy a great measure of success in controlling their loss reserve

[2] *Id* at 8.

margins to their best advantage. This is one of the most pressing problems because in times of poor underwriting experience companies cannot afford erratic changes in loss reserve margins to contribute to their adverse results and thus compound their difficulties.[3]

The study material on Part Seven of the Syllabus presents methods and techniques of loss reserving and presents principles of p/c company accounting. Some material, such as the article by Mr. Balcarek, spans both subjects and explains the impact of reserve changes on underwriting income. Every p/c actuarial candidate must understand the impact of reserve strengthening on underwriting income if he or she expect to pass this examination.

THE IMPACT OF CHANGES IN LOSS RESERVES ON UNDERWRITING INCOME

"Reserve strengthening" is used in the p/c insurance industry to explain the impact of reserve changes on underwriting income. In any industry, income is measured as the difference between revenues and expenses realized during an accounting period. The proper matching of revenues and expenses is the most difficult part of income measurement for any business. In the p/c insurance business this matching problem involves the proper matching of "earned premiums" and "incurred losses." "Reserve strengthening" is at the heart of this matching problem.

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[3] *Id* at 9.

The sources of revenue and expenses that determine income for a p/c insurer are "earned premiums," "incurred loss and loss expenses," "other expenses," "investment income," and "other income." "Earned premiums" are the revenues earned on policies in force during a calendar year. Insurers charge their customers for providing coverage. This change is the "premium" or the "written premium." Insurers then "earn" these premiums in proportion to time the policy has been in force.

"Calendar year incurred losses" (and loss expenses) are the total of the losses and settlement expenses paid during a calendar year plus the change in the loss and loss expenses reserves established on the books an insurer from the beginning of the calendar year to the end of the calendar year. "Other expenses" are the distribution costs of providing insurance. These include state and local taxes, commissions to agents and brokers, general overhead, and the like.

Statutory underwriting income (before income taxes) can be defined as:

Statutory Underwriting income =

Earned Premiums -
Calendar Year Incurred Losses and Loss Expenses -
Other expenses

For example, suppose an insurer earned $4,500,000 in premiums on policies in force. During the same time it paid $2,000,000 in losses and loss settlement expense. Suppose further it started the year with $1,900,000 in

reserves, ended with $2,500,000 in reserves and incurred $1,000,000 in other expenses. Then this insurer's statutory underwriting income would be

$900,000 =

$4,500,000 -
($2,000,000 + ($2,500,000 - $1,900,000)) -
$1,000,000

The incurred losses and loss expenses in statutory accounting are the losses and loss expenses incurred during the calendar year. These amounts, called "calendar year incurred losses" for brevity, may or may not match the premium revenue earned during the same calendar period. Calendar year incurred losses can arise from accidents that occurred during the year or from accidents that occurred in other years. The incurred losses and loss expenses that do match the premiums earned during the calendar year are the losses and loss expenses arising from insured accidents occurring during the calendar year.[4] These later incurred losses and loss expenses are called "accident year incurred losses."

[4] Under some policies, called claims-made policies, coverage is triggered when a claim is reported and not when it occurs. Accident year losses in this case includes the claims made during the calendar period.

RESERVE STRENGTHENING AND THE DIFFERENCE BETWEEN CALENDAR YEAR INCURRED LOSSES AND ACCIDENT YEAR INCURRED LOSSES

"Reserve strengthening" is generally defined implicitly or explicitly by p/c actuaries as the difference between calendar year incurred losses and accident year incurred losses when this difference is positive. "Reserve weakening" is generally defined by casualty actuaries as the difference between calendar year incurred losses and accident year incurred losses when that difference is negative.

The relationship of calendar year incurred losses and accident year incurred losses takes a simple mathematical form that is well known to casualty actuaries. In an article on the CAS Syllabus from at least 1977 to 1990[5], David Skurnick states this relationship:

> To prove this theorem, we first show that:
> [accident year y ultimate incurred losses] =
> [calendar year y paid loss] +
> [12/31/y required reserve] -
> [12/31/(y-1) required reserve]
>
> [...and...]
>
> As a corollary, a calendar year incurred loss will be the same as an accident year loss,

[5] Skurnick, David A., "A Survey of Loss Reserving Methods," *Proceedings of the Casualty Actuarial Society*, Volume LVIII, (1972), pages 16-62.

provided the beginning and ending carried total loss reserves are at the proper level or provided that these two are inaccurate by equal amounts.

Where an insurer's evaluation of its calendar year incurred losses do not match its evaluation of its accident year incurred losses for the same year, it necessarily has changed its estimate of the proper level of the required reserves from the beginning of the calendar year to the end of the calendar year. This difference flows directly into statutory underwriting income and creates a mismatch in the timing of earned premiums and incurred losses and loss expenses.

The formula[6] "Calendar Year Incurred Losses - Accident Year Losses" gives a simple definition to "reserve strengthening" when it is positive and "reserve weakening" when it is negative. It also defines these words in a way that accounts for changes in the reserve margins for whatever reason. It also relates, in a simple manner, underwriting income and the process of loss reserving.

An example will help clarify these concepts. Suppose an insurer starts the year 1994 with $1,000,000 in aggregate loss reserves, pays $2,000,000 in losses during the year, and ends the year with $1,400,000 in aggregate

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[6] The formula: Calendar Year Incurred Losses - Accident Year Incurred Losses translates into:

> [Calendar Year Paid Losses + (Year End Reserve - Year Beginning Reserves)] - [Losses Paid During the Calendar Year for the Current Accident Year + Year Ending Reserves for the Current Accident Year]

which can then be expanded into:

> [(Losses Paid During the Calendar Year for Prior Accident Years + Losses Paid During the Calendar Year for the Current Accident Year) - (Year Ending Reserve for Prior Accident Years + Year Ending Reserve for the Current Accident Year) - (Year Beginning Reserve for Prior Accident Years)] - [Losses Paid During the Calendar Year for the Current Accident Year + Year Ending Reserves for the Current Accident Year]

which then simplifies to:

> [(Year Ending Reserves Reserve for Prior Accident Years - Year Beginning Reserves) + (Losses Paid During the Calendar Year for Prior Accident Years]

reserves. The calendar year incurred losses are equal to \$2,400,000 (= \$2,000,000 + \$1,400,000 - \$1,000,000).

Suppose further that these calendar year numbers breakdown into the following accident year categories:

Beginning 1994 Calendar Year Reserves:

Accident Year 1991	\$200,000
Accident Year 1992	300,000
Accident Year 1993	500,000
Total	\$1,000,000

Loss Payments During the 1994 Calendar Year:

Accident Year 1991	\$200,000
Accident Year 1992	200,000
Accident Year 1993	300,000
Accident Year 1994	1,300,000
Total	\$2,000,000

Ending 1994 Calendar Year Reserves:

Accident Year 1991	\$ -0-
Accident Year 1992	200,000
Accident Year 1993	300,000
Accident Year 1994	900,000
Total	\$1,400,000

At the end of Calendar Year 1994, the insurer evaluated his Accident Year 1994 losses at \$2,200,000, the sum of the Accident Year payments (\$1,300,000) and the Accident Year 1994 reserves evaluated at the end of 1994 (\$900,000). The Calendar Year 1994 losses were \$2,400,000, which means there has been \$200,000 of reserve strengthening (\$2,400,000 - \$2,200,000.)

The Calendar Year losses can then be broken into payments and reserve changes for each individual Accident Year:

Calendar Year 1994 Losses =

Accident Year	*Ending Reserves*	+ *Payments*	- *Beginning Reserves*	= *Accident Year Contribution to Calendar Year*
1991	\$ -0-	\$ 200,000	\$200,000	\$ -0-
1992	200,000	200,000	300,000	100,000
1993	300,000	300,000	500,000	100,000
1994	900,000	1,300,000	-0-	2,200,000

The Calendar Year 1994 Losses less the Accident Year Losses are then: Ending Reserves on Prior Years plus the Payments on Prior Years less the Beginning Reserves on Prior Years. The current Accident Year 1994 losses are subtracted out (\$0 + \$100,000 + \$100,000 + \$2,200,000 - \$2,200,000 = \$200,000), leaving only reserve values and payments on prior accident years contributing to reserve strengthening.

The example makes clear the connection between "reserve strengthening" and the IRS Regulation, Regs. 1.846-3(c)(3). The difference between Calendar Year Incurred Losses and Accident Year Losses is the difference between end reserves and beginning reserves for prior accident years and payments on prior accident years claims made during the year. Regs. 1.846-3(c)(3) calls this number, when positive, "reserve strengthening."

RESERVE STRENGTHENING AND UNDERWRITING CYCLES

In measuring changes in statutory income, a p/c actuary must always consider the impact of changes in reserves. However, in studying changes in the level of statutory underwriting income over time the phenomenon of underwriting or profit cycles is of paramount importance. Any definition of reserve strengthening must consider the impact of the reserve strengthening during underwriting profit cycles.

In discussing the impact of reserve changes on underwriting income, reviewers often discuss this impact in terms of the effect of reserve strengthening and weakening on the underwriting cycle. Underwriting or profitability cycles have been with the p/c industry through out the twentieth century. Barbara Steward, a noted economist and analyst of profit cycles defines[7] these cycles as:

[7] Steward, Barbara D., "Profit Cycles in Property-Liability Insurance," in John D. Long and Everett D. Randall(eds.), *Issues in Insurance*, Volume 1, Third Edition (Malvern, PA: The American Institute for Property and Liability Underwriters, 1984), pp. 273-334.

> . . . a series of changes in some measure of profitability that follows a pattern similar to the pattern in previous and subsequent years of changes in profitability.

In the same article, Ms. Steward measured and charted profitability cycles over the period, 1944 to 1986.

Commentators[8] have ascribed these profit cycles to various causes. Some believe profit cycles stem from an inherent lag in information, the link between underwriting income and investment income, or the competitive structure to the p/c industry. Whatever the view, most commentators note a industry wide, inverse relationship between reserve strengthening and profit cycles. When accident year incurred losses are at their highest, and underwriting income is low, calendar year incurred losses are less than accident year losses with the effect of artificially increasing low underwriting income. On the other end of the underwriting cycle, when underwriting income is high, the current calendar year incurred losses are higher than the current accident year incurred losses. An obvious interpretation is that insurance managers build reserve strength when they have the money and release it when profits fall.

Kevin Ryan, the president of the National Council on Compensation Insurance ("NCCI"), described in a recent

[8] See for example, Feldblum, Sholom, "Underwriting Cycles and Insurance Solvency," (Casualty Actuarial Society 1992 Discussion Paper Program), pp. 383-438.

article[9] the impact of reserve strengthening on the workers compensation line of business.

> The impact of reserve changes on the loss ratio is obvious . . . they make bad years look better and good years look worse than they actually were. At the beginning of this cycle, from 1978 through 1981, extremely good results were obscured by modest reserve strengthening. In the following four years the opposite condition prevailed: the very dismal accident year results were masked by significant reserve weakening. As the cycle progresses, we see further reserve strengthening, which should persist into the 1990's.

His remarks are typical of actuaries evaluating the results of insurance company operations in terms of the relationship of profitability to loss reserves.

COMMON ACTUARIAL USES OF THE WORD RESERVE STRENGTHENING

Among some p/c actuaries, especially those that sign a "Statement of Actuarial Opinion", the term "reserve strengthening" has come to mean a one-time, significant change in the assumptions or methodologies used to compute the reserves which results in a material change to the reserves. However, this is a subset of all p/c actuaries and

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[9] Ryan, Kevin M., and Richard I. Fein, "A Forecast for Workers Compensation," *NCCI Digest*, Volume III, Issue IV (December 1988).

their work includes only a small percentage of all p/c actuarial work. Restricting the words "reserve strengthening" and "reserve weakening" to one-time changes in assumptions and methods would limit use of the term in measuring the impact of reserve changes on underwriting income.

This use of the restricted definition of the term "reserve strengthening" is a recent development. As late as year end 1989, only eight states required a Statement of Actuarial Opinion. Since that time, the instructions to the Annual Statement, required by every state, call for such a statement. The instructions now call for the opining actuary to examine the assumptions and methods used in determining loss reserves. The instructions call for the opining actuary to discuss several materials items including:

> if there has been any material change in the actuarial assumptions and/or methods from those previously employed, that change should be described in the statement of actuarial opinion inserting a phrase such as: . . .[10]

The Statement of Actuarial Opinion is a recent source of the restricted definition of reserve strengthening.

It is true that reserve strengthening and reserve weakening can be caused by changes in valuation methods and assumptions. However, there are several important situations where this restricted definition will not fit. For

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[10] National Association of Insurance Commissioner, Annual Statement Instructions: Property and Casualty, (1993 ed.), page 9.

example, the broad effect of reserve strengthening and weakening on the underwriting cycle's profitability is too systematic to be solely related to idiosyncratic changes at individual companies.

Even among p/c actuaries that act as loss reserve analysts only, the restricted definition of "reserve strengthening" will not always fit their work. Loss reserves represent a loss analyst's estimate of the monies to by paid in the future for insured accidents occurring in the past. At the time of valuation there is a range of possible outcomes. Good reserving procedure dictates an analyst use several methods to quantify loss reserves. After using several methods, he or she uses judgment to weight the likelihood of the several methods. For most reserve evaluations, it would be hard to separate changes in assumptions and methods from changes in judgment and the impact of these changes on loss reserves. If reserve strengthening and reserve weakening is to have a universal meaning, then it must mean the impact of reserve changes on calendar year underwriting income and not the meaning developed by some for the Statement of Actuarial Opinion.

Two broad categories are sometimes used to discuss loss reserving approaches. One approach is the direct approach of loss reserving, while the other is the indirect approach of loss reserving. In the direct approach the loss reserves are established for each part of the claims inventory; known claims, Incurred-But-Not-Reported-Claims ("IBNR")

and loss adjustment expenses ("LAE".)[11] The sum total of all the pieces represent the estimated loss liabilities of the insurer. Among claims adjusters and claim management personnel, increases in reserves on individual claims is sometimes called "reserve strengthening", but increases in the reserves for individual claims may be offset by decreases in the IBNR reserves. Thus, the adjusters' definition of "reserve strengthening" has a very limited use in determining underwriting income.

In the indirect approach, the losses needed to ultimately settle claims ("ultimate losses") are first determined. The difference between ultimate losses and paid losses are an estimate of loss liabilities. To see the interplay of judgment, assumptions and methods, one only has to look at some widely used indirect methods of reserve valuations.

Most indirect loss reserve methods assume a stable pattern of claim emergence and claim settlement. Actuarial loss reserve methods are only limited by the goals of a loss reserve review and the imaginations of the loss reserve analysts. Even so, there are some methods that appear most often in actuarial reports. They are loss development methods, exposure methods, and Bornhuetter/Ferguson methods.

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[11] This components can be further broken down to reserves established on reported claims (Adjusters Case Reserves), reserves for further increases reported claims (Supplemental Reserves), reserves for direct settlement costs (Allocated Loss Adjustment Expense Reserves, and indirect settlement costs (Unallocated Loss Adjustment Expenses.)

Loss development methods assume the recorded losses or claim counts grow in a stable manner. Loss development methods use the growth rates (known as age-to-age development factors) to project final values. The loss development methods assume losses, claims, or other statistics grow during development periods in a regular way. By analyzing the growth rates during common development periods, the loss reserve analyst attempts to forecast future patterns of growth.

Exposure methods relate losses and claims to some measure of exposure. The analyst adjusts exposure units, losses, and claims from older periods to bring this data to current conditions. Adjusted data then provide an estimate of the relationships between exposure units and losses or claims for the latest period. This method is often used when direct measurements of losses are too immature to give reliable projections of mature losses.

Exposure units measure the amounts at risk in a book of business. They can be fixed physical quantities such as the number of cars insured for a year. They can also be quantities that vary with time. If the exposure bases are not of the fixed physical type, they must be adjusted to the level of the immature year.

Bornhuetter/Ferguson methods are hybrid methods. They blend losses estimated using an exposure method with losses estimated using the development history embedded in a loss development method.

If a company were to use only one method, say the loss development method, then "reserve strengthening"

might be synonymous with a change in methods or assumptions. For example, in the loss development method, the loss reserve analyst must project reported losses to their ultimate settlement values. The last period of projection is known as the "tail." The loss reserve analyst must project from the time the company loss data ends to the time when all settlements are completed. Many companies using a loss development approach to loss reserving quantify their "tail factors" using industry-wide data. If a company increased its "tail factors," then the reserves on older accident years would increase. Calendar year income would then decrease due to "reserve strengthening" and this "reserve strengthening" could be traced back to the changes in "tail factors." This is a situation where the restrictive definition and my definition would agree.

The situation described in the preceding paragraph is common, but what is more common is the situation where the loss reserves stated in the Annual Statement represent a judgmental weighing of combinations of Loss Development methods, Bornheutter/Ferguson methods and Exposure methods. From year to year the assumptions underlying each method can change and the judgmental weighing of the combination of methods can change. In a loss reserve opinion, required as part of the Annual Statement filings to state regulators, a p/c actuary may well describe these changes as material changes in assumptions and methods, but he or she would not be able to separate the impact of changes in assumptions, methods and judgment on underwriting income.

Indirect methods of loss reserving depend on actuarial data related to the frequency and severity of loss,

exposure units, loss development factors and other actuarial data. In direct methods, the components of the loss reserve are separately quantified. There is a separate quantification for the components known as case reserves, supplemental reserves, IBNR reserves, and LAE reserves. The direct method of loss reserving is even less susceptible to the restricted definition of "reserve strengthening." This is because the direct method is often dependent, at least in part, on management's view of operations. Loss reserves are often set based on the relative size of these reserves to premiums, individual reserves, claim counts, policy counts, or other measurements of business activity. Separating the effect of reserve changes in these components due to changes in assumptions and methods is harder still than in the indirect method.

The loss reserve practice of Atlantic Mutual as of December 31, 1985 and December 31, 1986 are examples of a direct method of loss reserving. They are also examples where the restrictive definition of "reserve strengthening" would not fit the common use of this term. According to Atlantic Mutual's p/c actuary, Richard J. Hertling, FCAS:[12]

> Atlantic Mutual did not establish its booked unpaid losses by first estimating an amount of ultimate losses incurred loss and then subtract paid losses from that figure. Instead, Atlantic Mutual made separate calculations of each component of unpaid losses.

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[12] Letter of June 28, 1994 from Peter K. Lathrop to Phillip A. Pillar regarding *Atlantic Mutual Insurance Co. and Includible Subsidiaries v. Commissioner, USTC Docket No. 25767-93.*

In an attachment to that same letter, an exhibit displayed the adverse development of Atlantic Mutual's December 31, 1985 and December 31, 1986 loss reserves as of December 31, 1993. At December 31, 1985, the reserves started at $474.2 million and developed to $562.7 million, an increase of $88.5 million by December 31, 1993. The total "reserve strengthening," as defined in this report, would be $88.5 million, or 18.7% of the starting reserve. Using the restrictive definition of "reserve strengthening," however, Atlantic Mutual may not have done any "reserve strengthening."

According to Mr. Hertling, the method used to set reserves at Atlantic Mutual was as follows:

> Atlantic Mutual's unpaid losses and unpaid loss adjustment expenses at December 31, 1985 and December 31, 1986 consisted of the following three elements:
>
> (1) the aggregate of the individual estimates of unpaid losses on claims that had been reported to Atlantic Mutual by year-end ("case losses" or "reported losses"),
>
> (2) the estimated unpaid losses on claims that had occurred by year-end but had not been reported to Atlantic Mutual as of that date ("incurred but not reported losses" or, simply, "IBNR losses"), and
>
> (3) unpaid loss adjustment expenses ("LAE").

Atlantic Mutual included management reserves for both losses and allocated LAE (ALAE) as deemed necessary. Theses management reserves were in existence since 12/80. The 12/85 and 12/86 management reserves pertained mostly to ALAE and were established because it was recognized that the calendar year paid to paid method for setting ALAE reserves resulted in inadequate ALAE reserves. The reserves were established to address this inadequacy.

In the process described by Mr. Hertling, the loss reserving decisions were diffused throughout Atlantic Mutual's organization. The claims department determined the individual case reserves (without, apparently, an actuarial estimate to the Incurred-But-Not-Enough-Reported reserve[13]), The accounting department determined the LAE reserves. The actuarial department monitored the reserves during the year. And senior management determined the total reserve by determining a residual amount called the "management reserve." Reserve strengthening did occur for the December 31, 1986 total reserves, but it may not have been as a result of a change in reserve assumptions and methods.

The loss reserving process for most insurance companies is a complex process. In some companies, such as Atlantic Mutual, different functional areas determine parts of the overall loss reserves. In other companies the loss

[13] P/C actuaries have long recognized that the sum total of reserve on reported claims, case reserves, will not be adequate to settle these known cases. When reserves are established directly, one component will be the Incurred-But-Not-Enough-Reported or Supplemental reserve.

reserving process may be divided along marketing divisions. Divisions that handle large national accounts can set loss reserves for their markets. Likewise, divisions that handle small commercial or retail markets can set loss reserves for their markets. The restrictive definition of "reserve strengthening" will not fit these situations as it did not fit Atlantic Mutual. In these common, complex situations most p/c actuaries would define "reserve strengthening" using the definition given at the beginning of this report, i.e., "reserve strengthening" is the difference between calendar year incurred losses and accident year incurred losses when that difference is positive.

DISTINGUISHING RESERVE ADEQUACY AND RESERVE STRENGTHENING

Two terms that are easily confused when discussing loss reserves are the terms "reserve strengthening" and "reserve adequacy." The differences between these two terms are especially important when discussing the impact of changes in loss reserves on underwriting income. By an "adequate" loss reserve, a p/c actuary means that the loss reserves established on the books of an insurer as of the accounting date represent the amount of money required to fully settle claims that have already occurred. Thus, reserve adequacy is a concept related to an insurers financial position *at one point in time*. Reserve strengthening, both as used generally and in its restricted sense, describes the impact of changes in reserves from *one accounting date to another*.

The balance sheet of an insurer represents the financial position of an insurer at a point in time. The "surplus as regards policyholders" is the statutory equivalent

of "owner's equity" and is the difference between the assets and liabilities of an insurer. If loss reserves are inadequate, then the liabilities are understated and the surplus as regards policyholders if overstated. In this case the financial position of an insurer is not as strong as its accounting statements would indicate. Thus reserve adequacy is related to the financial position of an insurer.

As stated before, "reserve strengthening" is related not to the financial position of an insurer at one time, but rather to income. Income represents the change in financial position from one accounting date to another. At any point in time, an insurer establishes the reserves for the most recent claims and re-establishes the reserves for claims first established during prior accounting period. "Reserve strengthening" has a negative impact on income from the subsequent valuation of these older claims.

Reserve adequacy can only be measured with hindsight. Insurers are supposed to establish the full liabilities for loss at year end. These liabilities can only be estimates. Even so, they represent "best estimates" and are not suppose to be deliberately understated or overstated. With time, however, the reserves established at a point in time for a particular block of accident year claims may prove to have been overstated or understated at prior accounting dates.

The impact of "reserve strengthening" on underwriting income can be determined by looking at the runoff of reserves from the beginning of the accounting period to the end of the accounting period. At the beginning of the accounting period there are no reserves for the current

accident year, only for prior accident years. Thus, "reserve strengthening" as it impacts underwriting income is only concerned with the change in reserve adequacy for prior accident years.

CONCLUSIONS

Loss reserving has a pervasive influence on the income determination of a property-casualty insurance company. Reserve strengthening and reserve weakening can be understood in terms of the effect of reserve changes on income. A definition that restricts reserve strengthening to changes in assumptions and methods only and not to the overall effect of reserve changes is too restrictive to use in the determination of income.

A natural definition that highlights the effect of changes in reserves on income is one where "reserve strengthening" is the positive difference between calendar year incurred losses and accident year incurred losses.

/s/ Raymond S. Nichols   Dec. 15, 1994
Raymond S. Nichols
Date

BIOGRAPHICAL SUMMARY AND QUALIFICATIONS

I earned a bachelor of arts degree in mathematics from the University of Bridgeport and a master of science degree in mathematics from Ohio State University.

I am a Fellow of the Casualty Actuarial Society (CAS) by examination; I also am a Member of the American Academy of Actuaries, the Casualty Actuaries of New England, and the international nonlife actuarial organizations ASTIN and AFIR.

I am currently a member of the Casualty Task Force of the National Association of Insurance Commissioners ("NAIC"). I served as chair of the Data Management and Information Committee for the CAS from 1988 to 1990 and served as a member for six years prior to becoming chairman. I am a member of the Textbook Committee for the Insurance Accounting and Systems Association ("IASA") and wrote the chapter on loss reserving for the latest edition of their property - casualty accounting textbook.

My work experience includes 21 years in the property-casualty insurance industry in actuarial, management, consulting and regulatory positions. I have been extensively involved in rate making and reserving activities both for small, medium and large primary insurance companies. For 15 years I held positions at three different insurance companies, being the chief actuary for two and a senior actuarial officer for a third.

From 1973 to 1979, I trained as an actuary with Travelers Insurance Group. At the end of 1979 to the middle

of 1984, I was the chief actuary of the Covenant Group, a regional insurance group domiciled in Connecticut. After leaving Covenant Group in 1984, I returned to Travelers as second vice president and actuary in charge of a loss reserving and product costing for commercial lines. In 1988, I was recruited by the New Hampshire Group, a division of American International Group ("AIG"), to serve as senior vice president and chief actuary.

For five years, after leaving AIG, I was an actuarial consultant both with a large international actuarial consulting firm (Milliman & Roberston, Inc.) and as an independent in my own private practice. My most recent position is that of Director of the Property Casualty Division of the Connecticut Insurance Department.

Appendix I

Raymond S. Nichols
Fellow of the Casualty Actuarial Society
Member of the American Academy of Actuaries

75 North Quaker Lane
West Hartford, Connecticut 06119
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Experience Highlights	*Connecticut Insurance Department*, Hartford, CT.
Presently	*Director of the Property and Casualty Division.* Recruited to this senior regulatory position by the Commissioner of Insurance for the State of Connecticut. Responsible for all property and casualty insurance rate and policy form regulation. Also, responsible for the regulation of the involuntary insurance markets in the state. Manage a professional staff of twelve including two principal examiners, five associate examiners, one actuary, two system analysts, and two clericals. Report to the Commissioner of Insurance.

1991 to 1994	*Private Consulting Practice*, West Hartford, CT. *Consulting Actuary.* Developed an independent casualty actuarial consulting practice. This practice provided actuarial management services to small insurance companies and other small insurance organizations. Services included loss reserving, ratemaking and product costing, filing and regulatory management, management report development, financial planning, and reinsurance reviews.
1989 to 1991	*Milliman & Robertson, Inc.*, Bloomfield, CT. *Consulting Actuary.* Employed to develop a casualty actuarial consulting practice in the Hartford office and to support the casualty staff in the Boston office of this international actuarial consulting firm. Billed approximately four hundred thousand dollars in the first full year of the Hartford casualty practice. Developed major clients among insurance regulators, highly protected risk insurers, general insurance companies and self insurers. Completed a major study of the Connecticut Automobile Insurance System for the Connecticut Insurance Department.

1988 to 1989 — *AIG/New Hampshire Insurance Group,* Manchester, NH.

Senior Vice President and Chief Actuary. Recruited to this subsidiary of the American International Group by the President. Responsible for managing all actuarial functions for this general insurance company whose annual revenue approached one billion dollars. Reorganized the actuarial staff into three departments: actuarial systems, costing/reserving and pricing. The primary work products of these departments were financial plans and loss budgets, profit center profitability reports, rate reviews and price changes, new product pricing studies, internal and external loss reserve reports, management information systems, agent experience reviews and statistical studies for filing support. Part of the senior team reporting to the President.

1984 to 1988 — *The Travelers Insurance Companies,* Hartford, CT.

Second Vice President and Actuary. Recruited back to the Travelers by the CFO of the newly organized Agency Marketing Group. Built a professional department of twenty including four actuarial officers, twelve actuaries and four support staff

members. Responsible for measuring the needed levels of loss and allocated loss expense reserves generated by one and a half billion dollars of commercial lines premiums per year. Also, responsible for testing the adequacy of commercial lines rates. Established quarterly reserve reviews for senior management, semiannual rate reviews for a competitive pricing unit, and monthly reserve reports for a financial reporting department. Represented Travelers at various bureau and pool actuarial committees including those of the Insurance Services Office, the New York Medical Malpractice Insurance Association, and the Industrial Risk Insurers. Coordinated the efforts of an MIS applications unit. Responsible for developing actuarial students apprenticed in commercial lines.

1980 to 1984 — *Covenant Group*, Hartford, CT.

Second Vice President and Chief Actuary. Reported to the CFO. Responsible for the actuarial function of an $80 million regional multi-line property casualty insurance company. Broadened the function to include product development and market support system services along with more traditional financial reporting and loss reserving services. Organized a staff of four actuarial and technical support professionals. Trained loss

reserve specialists to do quarterly reviews of the company's loss and loss expense reserves. Supplied expertise and pricing information to the marketing department for their reviews of premium rates. Designed contracts and financial models for agent compensation agreements. Designed dividend programs for the product management department to offer as new products. Oversaw the development of an actuarial data base with associated access programs. Helped cost claim settlement contracts with outside legal firms for the claim department. Aided in the analysis and negotiation of reinsurance contracts.

1973 to 1980 — *The Travelers Insurance Companies*, Hartford, CT.

Senior Actuarial Assistant. Provided actuarial pricing support to middle management for various lines of insurance including commercial property, worker's compensation, homeowners, and private passenger automobile. Supervised the streamlining and enhancement of an automated system for reviewing private passenger automobile rates. Represented the Travelers at various industry bureau meetings. Supervised the work of other actuarial students and technical support personnel. Aided in the loss rating of large insureds.

The Travelers Insurance Companies, Hartford, CT.

Programmer Analyst. Prepared detailed system specifications and COBOL program instructions according to company standards. Maintained and enhanced two large premium and tax systems.

Professional — Fellow of the Casualty Actuarial Society.

Member of the American Academy of Actuaries.

Associate of the Conference of Consulting Actuaries.

Member of the Casualty Actuaries of New England.

Member of ASTIN, the international non-life actuarial association.

Member (1985 - 1991) and Chairman (1990 - 1991) of the Casualty Actuarial Society's Committee on Data Management and Information.

Member of the American Risk and Insurance Association.

Other

Author of the Insurance Accounting and Systems Association's ("IASA") 1991 textbook chapter on loss reserving.

Member of Who's Who Worldwide and included in the 1993/1994 Who's Who Registry of Global Business Leaders.

Past lecturer in forecasting and reinsurance at the University of Hartford.

Past lecturer at the Casualty Loss Reserve Seminar on basic reserving methods and reserving methods for small companies.

Past lecturer at the Casualty Actuarial Society's Ratemaking Seminar on data for ratemaking.

Student of the Insurance Data Management Association ("IDMA"). Completed seven of eight professional examinations leading to the Certified Insurance Data Manager ("CIDM") designation.

Education

The Ohio State University, Columbus, Ohio. Masters of Science, Mathematics, 1973.

The University of Bridgeport, Bridgeport, CT. Bachelors' of Arts, Mathematics, 1971.

Report

of

Ruth E. Salzmann, F.C.A.S., M.A.A.A.

Respondent's Expert

in

Atlantic Mutual Insurance Co. et al., Petitioner

v.

Commissioner of Internal Revenue, Respondent

Docket No. 25767-93

United States Tax Court

December 12, 1994

RESPONDENT'S EXHIBIT AG
DOCKET NO. 25767-93

Introduction

My assignment from the IRS was to define the term "reserve strengthening" and to explain what the term means in the property and casualty ("P/C") insurance industry. This report will, therefore, include definitions of reserve strengthening, explain how reserve strengthening affects the income statement, describe its measurement and the time-delay needed for such a measurement, and discuss the common misconceptions in its use and measurement.

To introduce myself, I am a Fellow of the Casualty Actuarial Society and a member of the American Academy of Actuaries. My employment through 1983 was with major P/C insurance companies with executive responsibilities in actuarial areas. Currently I am a consultant on matters relating to P/C loss and loss expense reserves. My industry and professional activities were primarily on subjects relating to P/C financial reporting, as were my many published works. My current resume is attached as Appendix I.

General Background Relating to "Reserve Strengthening":

The term "reserve strengthening" is most often used in connection with the income statements of P/C insurers. All income statements match costs with revenues for an accounting period. In P/C insurance, the costs represent the losses generated by the protection provided during the accounting period - or the losses that occurred during that same period of time. As many of the losses[1] that occur take considerable time to settle, the unpaid amounts on these losses as of the accounting date become liabilities, and are commonly referred to as loss reserves[2] in P/C insurance literature. The losses incurred for the accounting period therefore become the sum of losses paid during the accounting period, plus the loss reserves at the end of the period, less the loss reserves at the beginning of the period. These loss reserves are not only unknown as to number (many are not yet reported),[3] but are also unknown as to amount. Settlement costs are not fixed and can vary widely in size and in the timing of settlement, both of which are affected by future contingent developments.

Because of these uncertainties, loss reserves are "best estimates". Their accuracy will be determined after all

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[1] For purposes of this report, the terms "loss" and "claim" are used interchangeably, and "loss/claim amounts" include loss expenses (costs associated with the settlement of losses).

[2] In this report, "loss reserves" are the undiscounted value of unpaid losses.

[3] Reserves for these claims are known as "IBNR," an abbreviation for "incurred but not reported".

settlements are final. Reserves are adequate when reported reserves exceed future payments thereon, and are inadequate when they fall short. The "margin" of adequacy (inadequacy) is the adequacy (inadequacy) in absolute dollars.[4] And when this margin of adequacy in the beginning and ending loss reserves changes, the effect is to over or understate losses incurred and thus distort the net income reported for the accounting period. When the margin of adequacy increases (or the margin of inadequacy decreases), it is called "reserve strengthening." When the reverse is true, it is called "reserve weakening".

Definitions of "Reserve Strengthening"

The definition of "reserve strengthening" (or "reserve weakening") can, therefore, be stated as follows:

> Reserve strengthening (or reserve weakening) is a term used in connection with P/C income statements. It refers to the dollar change in the margin of adequacy in the beginning and ending reserves for unpaid losses for that accounting period. The change can be *for whatever reason and for any amount*. If ending reserves are more adequate (or less inadequate) than the beginning reserves, there is reserve strengthening in the accounting period and net income is understated; conversely, if ending reserves are less adequate (or more inadequate), there is reserve weakening and net income for the accounting period is overstated.

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[4] Because adequacy measurements are negative quantities (as explained later), the elimination of signs is less confusing to the reader.

Rephrasing this same definition in other ways, "reserve strengthening" can also be stated as follows:

1. The excess of calendar-year reported losses over the final paid costs of losses that occurred in the respective accident year;

2. The effect on calendar-year results due to an increase in the margin of adequacy in the ending reserve (over the beginning reserve);

3. The excess of reported losses over losses for the current accident year *if* the latter are accurately estimated.

Measurement of "Reserve Strengthening"

Reserve strengthening, by definition, is the dollar change in the margin of adequacy of ending over beginning loss reserves. To measure the strengthening (weakening), one must first measure the adequacies of loss reserves involved. A loss reserve is adequate when the subsequent developments on those unpaid claims are less than the reserve originally reported for them. The adequacy (inadequacy) of a 12/31/n reserve is derived by subtracting that reserve from the sum of subsequent payments and *estimated* amounts still unpaid on ≤ accident year claims. Thus an adequacy is a minus quantity in P/C financial reporting. Adequacies are generally compiled annually by development age (reserve date being 0), but these compilations continue to be estimates until all losses occurring on or before the reserve date are final. At that point in time when actual adequacies become know, the

dollar change in the margins, or the actual reserve strengthening, can also be determined. The following is an illustration of such a calculation:

Measurement of Reserve Strengthening in Calendar Year (n)

Accounting Date	(1) Reported Reserves	(2) Final Subsequent Payments	(2) - (1) Adequacy (-) Inadequacy (+)
12/31/n	$10,000	$9,500	$-500
12/31/n-1	9,000	9,100	100
Δ	1,000	400	-600

The reserve strengthening that occurred in calendar year (n) was $600, the change from an inadequacy of $100 as of 12/31/n-1 to an adequacy of $500 as of 12/31/n.

Common Uses and Interpretations of "Reserve Strengthening"

It takes time to get an accurate measurement of the actual reserve strengthening that occurs in any accounting period - and in most cases, a long time. Preliminary statements regarding strengthening are therefore only approximations. In analyzing P/C income statements, it is the *need-to-know now* that has given rise to various interpretations and measurements of reserve strengthening. If one does not have to put a value on it, the term generally means an increased confidence in the adequacy of current

reserve levels. When an amount is stated, the amount, (representing the increased confidence) is often rather crudely measured in non-actuarial circles. Sometimes the dollar measurement is the dollar increase in bulk reserves,[5] including or excluding IBNR. The more common use of the term "reserve strengthening" is a euphemism for the deficiency,[6] or inadequacy, of prior reserves that adversely impacted the income reported in the current accounting period. The underlying assumption in this latter usage, knowingly or unknowingly, is that "this year end we've got it right". It was because of these general misconceptions that prompted me to include the proper definition of "strengthening" in my book.[7]

Conclusion

The term "reserve strengthening" can be an important component in the income statement of P/C insurance companies. Because of the delay needed to obtain a precise measurement, only estimates are available on a timely basis. In non-actuarial reporting, the term often means (and is a euphemism for) the deficiency, or inadequacy, of prior reserves that adversely affected the earnings in the current accounting period. It is this meaning or measurement that is

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5 Bulk reserves are those not identified by claim filed that provide for claims not yet reported (IBNR) and for adjustments to aggregate case estimates on claims already reported.

6 The excess of the amount paid in the current year plus the amount still unpaid at year end on prior accident-year losses over the loss reserve reported a year ago.

7 See an excerpt from my book in Appendix II to this report.

consistent with the formula used by the IRS in its regulation denying fresh start for reserve strengthening. Though this meaning or measurement is not correct, it is consistent with a common usage of the term in non-actuarial circles.

/s/ Ruth E. Salzmann
Ruth E. Salzmann

Appendix I

BIOGRAPHICAL DATA

Name:

Ruth E. Salzmann

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Highland, Wisconsin

Degrees and Designations:

Ph.B. - University of Wisconsin- Madison, 1940

FCAS - Fellow, Casualty Actuarial Society, 1947 - present and Past President
MAAA - Member, American Academy of Actuaries, 1965 - present

Other Insurance Involvements:

Member, MAF (Midwestern Actuarial Forum), 1968 - _____, and Past President

Director, Sentry Insurance A Mutual Co.

Director, Hanseco Insurance Co.

Casualty Actuarial Society Contributions:

Committee, 1964-68, Committee on Distribution of Losses

Committee, 1964-67, Committee on Annual Statement

Committee, 1964-66, Education Committee

Committee, 1964-67, Examination Committee

Panel, 1965, Report of Committee on Annual Statement

Panel, 1966, Reinsurance Today

Paper, 1967, Schedule P on a Calendar/Accident Year Basis, *PCAS* LIV, 120

Review, 1967 Underwriting Profit from Investments, *PCAS* LIV, 23

Council, 1967-69

Chairman, 1968-71, Committee on Annual Statement

Committee, 1968, Committee On Program

Committee, 1968-75, Examination Consultants

Panel, 1969, Holding Companies, -- Conglomerates, and Congenerics on the Insurance Scene

Panel, 1970, The Changing Annual Statement

Committee, 1970-72, Liaison Representative on Joint Actuarial Committee On Financial Reporting

Paper, 1972, How Adequate are Loss and Loss Expense Liabilities, *PCAS* LIX, 1

Author's Response, 1972, How Adequate Are Loss and Loss Expense Liabilities, *PCAS* LIX, 16

Panel, 1974, Profitability and Investment Income by Line By State

Workshop, 1976, Early Warning Systems

Panel, 1976, The Discounting of Loss Reserves

Vice President, 1976

Chairman, 1976, Planning Committee

Ex Officio, 1976, Program Committee

President Elect, 1977

Committee, 1977-78, Program Committee

President, 1978

Presidential Address, 1979, Accountability: The Actuarial Imperative, *PCAS* LXVI, 74

Ex President, 1979-80

Committee, 1979-84, Nominating Committee

Paper, 1981, RLS Yardsticks to Identify Financial Weakness, *PCAS* LXVIII, 172

Chairman, 1981-82, Nominating Committee

Committee, 1985-88, Committee on Review of Papers-Consultants

Business Experience:

1983 - 1984, Sentry Insurance, Exec. V.P. and Actuary

1968 - 1983, Sentry Insurance, V.P. and Actuary

1967 - 1968, INA, Secretary - Und.

1964 - 1967, INA - Life, Group Actuary

1959 - 1964, INA, Assoc. Actuary

1940 - 1959, Hardware Mutuals, Assoc. Actuary

Publications:

Books: "Estimated Liabilities for Losses and Loss Adjustment Expenses," 1984, Prentice-Hall

Chapters in "Property - Liability Insurance Accounting," IASA

Chapter 3 - Est. Liab. for Losses and LAE, 1974

Chapter 4 - Est. Liab. for Losses and LAE, 1984, 1986, 1988

Proceedings of the Casualty Actuarial Society:

Papers:

1963, Commercial Package Policies - Rating and Statistics, *PCAS*, Vol. L, p. 87

1963, Rating by Layer of Insurance, *PCAS*, Vol. L, p. 15

1967, Schedule P on a Calendar/Accident Year Basis, *PCAS*, Vol. LIV, p. 120

1972, How Adequate Are Loss and Loss Expense Liabilities, *PCAS*, Vol. LIX, p. 1

1981, RLS Yardsticks To Identify Financial Weakness, *PCAS*, Vol. LXVIII, p. 172

Addresses:

1979, Accountability: The Actuarial Imperative (Presidential Address), *PCAS*, Vol. LXVI, p. 74

1992, Address to New Members, *PCAS*, Vol. LXXIX. p. 149

Review of Papers:

1961, Reserves for Reopened Claims, *PCAS*, Vol. XLVIII, p. 192

1967, Underwriting, Profit From Investments, *PCAS*, Vol. LIV, p. 23

IASA Proceedings:

Numerous (1949 - 1958)

REFERENCE ON "STRENGTHENING"

Source: Salzmann, Ruth E., "Estimated Liabilities for Losses and Loss Adjustment Expenses," 1984

STRENGTHENING *Strengthening* is the term used to denote the increase in the liability level, or margin, that occurs during an accounting period. The term, as used in property-casualty insurance, is generally a misnomer. If a statement is made that reported results were adversely impacted by $X of "reserve strengthening," the $X generally represents the unfavorable runoff of the beginning liabilities. This runoff is absorbed in the current accounting period, but if the ending liabilities for the new accident year are also inadequate by the same dollar amount, the reported results are not "adversely impacted." Likewise, if the beginning and ending liabilities contain the same margin of adequacy, then no liability strengthening has occurred during the

period. The amount of liability strengthening or weakening that occurs in any calendar year will not be known until developments on both the beginning and ending liabilities are final. A statement regarding the strengthening of "reserves" is true only if the liabilities for new claims are at the strengthened level of old claims. No such guarantee is possible. All statements regarding "reserve strengthening" are approximations at best.

REBUTTAL REPORT

ATLANTIC MUTUAL INSURANCE COMPANY
MUTUAL INSURANCE COMPANY

AND INCLUDIBLE SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE

TAX COURT NO. 25767-93

Prepared by:
Raymond S. Nichols, F.C.A.S., M.A.A.A.
January 11, 1995

RESPONDENT'S EXHIBIT AF
DOCKET NO. 25767-93

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EXECUTIVE SUMMARY

This report is a rebuttal to the reports of the petitioner's expert witnesses in the Tax Court Case: Atlantic Mutual Insurance Company and Includible Subsidiaries versus the Commissioner of Revenue ("the Atlantic case"). In their reports to the Court, both Irene Bass and James Mac Ginnitie gave definitions and examples of reserve strengthening that actuaries could understand but could not use in the common actuarial analysis of income determination. Their definitions are not wrong, rather, they are specialized.

"Reserve strengthening" has several meanings within the property and casualty ("p/c") actuarial community. Even so, there is a primary use of the term "reserve strengthening" in describing the impact of changes in reserves on statutory income.[1] Neither Irene Bass's definition nor James Mac Ginnitie's definition could be used to determine that impact.

When describing the impact of changes in reserves on statutory income, the use of the term "reserve strengthening" simply means a positive difference between calendar incurred losses and accident year incurred losses. Other, less common uses of the term "reserve strengthening" appeal to actuaries conducting specialized tasks. These specialized tasks may be analyzing an insurer's solvency, formulating a loss reserve opinion, preparing a hindsight review of a

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[1] "Statutory income" includes investment income and underwriting income as stated in the NAIC Annual Statement.

reserve runoff, or other tasks. However, these are narrow aspects of p/c actuarial work.

In the sections on the report that follow, I restate the definition of reserve strengthening as it is commonly known. I then present an example of an insurer's reserve data as that data might change with time. Using this example, I then show how Irene Bass's definition of reserve strengthening and James Mac Ginnitie's definition of reserve strengthening differ from each other and from the common definition.

INTRODUCTION

Even the casualty reader of the expert witness reports in the Atlantic case will conclude that "reserve strengthening" does not have one distinct meaning at all times for p/c actuaries. My report to the Tax Court opined that "reserve strengthening" is most often used in the p/c insurance industry to explain the impact of reserve changes on underwriting income. This use is widespread and critically important because reserve strengthening is tied to the matching of revenue and expenses in the accounting statements of a p/c company. The proper matching of revenues and expenses is the most difficult part of income measurement in any business.[2] In the p/c business this matching problem involves the proper matching of "earned premiums" and "incurred losses." Reserve strengthening is at the heart of this matching problem.

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[2] See for example, ***Intermediate Accounting***, Jan R. Williams, Keith G. Stanga and William W. Holder, 4th Edition, The Dryden Press, 1992, pages 48-60.

Where an insurer's year-end evaluation of its calendar year incurred losses do not match its year-end evaluation of the current accident year incurred losses, it necessarily has changed its estimate of the proper level of the required reserves from the beginning of the calendar year to the end of the calendar year. This difference flows directly into statutory underwriting income and creates a mismatch in the timing of earned premiums and incurred losses and loss expenses.[3]

The formula [Calendar Year Incurred Losses - Accident Year Losses] gives a simple definition of reserve strengthening when it is positive, and reserve weakening when it is negative. It also defines these words in a way that accounts for changes in the reserve margins for whatever reason. It also relates, in a simple manner, underwriting income and the process of loss reserving.

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[3] After preparing my report the Tax Court, but before preparing this rebuttal, I read Ruth Salzmann's expert witness report in the Atlantic case. According to her report, Ms. Salzmann would require an accident year be evaluated at final settlement for all claims occurring in the accident year. While this is a theoretically pure definition, an actuarial evaluation is rarely completed after an accident year is settled. At the end of the calendar year, the reserves for the current accident year should be "best estimates" with an equal likelihood they will prove inadequate or redundant. At the end of a calendar year, when accounting statements are prepared and published, the best estimate of the impact of reserve changes on calendar year incurred losses is the difference between calendar year incurred losses and accident year incurred losses.

DISCUSSION AND ANALYSIS

Loss reserving if a fundamental p/c actuarial process that impacts the pricing of insurance products, the measurement of insurers income and the measurement of insurers financial position. Words such as "reserve strengthening," "reserve adequacy," "reserve margin," and others are sometimes used by p/c insurance actuaries in ways that are conflicting and confusing. However, it is possible among p/c insurance actuaries to communicate the context in which these words are used and to distinguish their meaning. Below is an example to help clarify this discussion, but first we must define some terms.

An "adequate reserve" is sometimes called the "required reserve." It can only be known with time as the claims incurred before the valuation date are all settled. The "carried reserve" is the reserve actually carried on the book of an insurer at a given accounting date. The difference between the "required reserve" and the "carried reserve" is the "reserve margin." It also cannot be known, except with the passage of time.

"Reserve adequacy" is a term related to an insurer's financial position *at one point in time*. "Reserve strengthening" describes the impact of changes in reserves *from one accounting date to another date*. As the term is commonly used, reserve strengthening is measured using the carried reserves from the beginning of the accounting period to the end of the accounting period. At both the beginning and the end of the period, carried reserves should be the best estimate of the required reserve given the information known as of the valuation date. Subsequent information may prove

the best estimate to be flawed. Nevertheless, when first established, a well-measured carried reserve should have an equal likelihood of being inadequate or redundant, relative to the required reserve.

At the end of an accounting period, the current accident year has only been measured once. It is not possible (for this accident year) to say the first carried reserve is different than the required reserve. For prior accident years, there are at least two carried reserves, the carried reserve at the beginning of the accounting period and the carried reserve at the end of the accounting period. Reserve strengthening is a positive difference between calendar year incurred loss and accident year losses. This difference involves these two carried reserves.

A change in reserve adequacy involves the difference between *two* carried reserves and *two* required reserves. This difference will not be known for years (when all open claims occurring before the respective accounting dates are finally settled). This difference can be described in terms of absolute dollars or relative percentages.

AN EXAMPLE

With those terms in mind, consider the following example. Suppose an insurer writes one line of automobile liability insurance and has the reported incurred losses and loss reserve information shown in the following table:

Incurred Losses:	Accounting Date		
Accident Year	12/31/1992	12/31/1993	12/31/2025
1991	$ 1,000,000	$ 1,200,000	$ 1,300,000
1992	2,000,000	2,100,000	2,200,000
1993	N/A	3,000,000	4,000,000

Carried Reserves:	Accounting Date		
	12/31/1992	12/31/1993	12/31/2025
1991	$ 500,000	$ 500,000	-0-
1992	750,000	600,000	-0-
1993	N/A/	1,000,000	-0-
Total	$ 1,250,000	$ 2,100,000	-0-

Required Reserves:	Accounting Date		
	12/31/1992	12/31/1993	12/31/2025
1991	$ 800,000	$ 600,000	-0-
1992	950,000	700,000	-0-
1993	N/A	2,000,000	-0-
Total	$ 1,750,000	$ 3,300,000	-0-

The calendar year incurred losses for 1993 are $3,300,000 and are due to the impact of accident year incurred losses. These accident year losses include $3,000,000 for 1993 and a total change of $300,000 in incurred losses for 1991[4] and 1992[5] ($3,300,000 = $3,000,000 + 200,000 + 100,000). The reserve strengthening of $300,000 is the positive difference between calendar year incurred losses ($3,300,000) and accident year incurred losses ($3,000,000).

By the year 2025 it is possible to look back and determine the relative adequacy of the reserves as 12/31/92 and 12/31/93. The following table displays the difference between the required reserve and the carried reserve:

Accounting Date	*Carried Reserve*	*Required Reserve*	*Difference*	*Relative Adequacy*
12/31/92	$1,250,000	1,750,000	(500,000)	71.4%
12/31/93	$2,100,000	3,300,000	(1,200,000)	63.6%

We see in this example that the calendar year incurred losses included $300,000 of reserve strengthening from prior accident years, but that "reserve adequacy" decreased on an absolute dollar basis by $700,000 ($700,000 = $1,200,000 - 500,000) and on a relative percentage basis

[4] $200,000 is the change from $1,000,000 as of 12/31/1992 to $1,200,000 as of 12/31/1993.

[5] $100,000 is the change from $2,000,000 as of 12/31/92 to $2,100,000 as of 12/31/1993.

by 7.8% (7.8% = 71.4% - 63.6). The reason for this apparent anomaly is that the carried reserve for accident year 1993 is in retrospect grossly inadequate at 12/31/93. As of 12/31/93, however, that inadequacy is unknown and does not enter into calculations of reserve strengthening at that time.

Irene Bass and James Mac Ginnitie have each given difference definitions of reserve strengthening. Irene Bass is using "reserve strengthening" in a way that stresses the need for accounting statements to give full disclosure of all material financial information.[6] While this need for full disclosure certainly applies to reporting loss reserves, it is not directly related to income measurement. Irene Bass's definition of "reserve strengthening" is a restricted definition and is not the most commonly understood definition in the p/c insurance industry.

James Mac Ginnitie implicitly gives a definition of reserve strengthening which is tied to reserve adequacy and the measurement of an insurer's financial position. This definition is different from that of Irene Bass and is not one that can be used to measure a p/c insurer's income. The primary and common use of the words "reserve strengthening" in the p/c insurance industry is a use tied to an analysis of an insurer's income. A simple, clean and actuarial definition of reserve strengthening is one that defines it as the difference between calendar year incurred

[6] For a discussion of "Disclosure" in accounting see, for example, *Intermediate Accounting*, note 2, *supra*.

losses and accident year incurred losses when that difference is positive.[7]

My example can be used to explain the differences between the definitions given defined in my report, Irene Bass's report, and James Mac Ginnitie's report. The next section analyzes Irene Bass's definition.

REPORT OF IRENE K. BASS, F.C.A.S.

Irene Bass, in her report,[8] creates a definition of the words "reserve strengthening," as follows:[9]

> *Definition of Reserve Strengthening*
>
> With the examples of what does and does not constitute reserve strengthening and with the NAIC instructions as background, a more comprehensive working definition of reserve strengthening for PC insurers can be developed. With respect to reporting reserves in the Annual Statement, reserve strengthening is said to have occurred if there is a one-time (or, at least, unusual and non-periodic), significant change in the and/or methodologies used to compute the reserves which results in a material change to the relative level of adequacy of the total reserve inventory.

Irene Bass states clearly that her definition is not one taken directly from actuarial literature.[10] She then describes the need for "disclosure" of "any especially significant events, coverage, retention or accounting changes that have occurred which must be considered when making such [loss reserving] analyses."[11] Among some p/c actuaries, especially those who sign a "Statement of Actuarial Opinion," the term "reserve strengthening" may well have come to mean disclosure of material one-time, significant change in loss reserving assumptions or methodologies. However, this is a subset of all p/c actuaries and their work includes only a small part of all p/c actuarial work. Irene Bass's definition of reserve strengthening is a restrictive definition and is related to the accounting principle of Disclosure.[12]

Irene Bass, in the Bass report, creates a definition of reserve strengthening that may meet the needs of opining loss reserve analysts, but could not be used to describe the impact of reserve changes on a p/c insurer's income statement. The

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7 It is possible to reevaluate a given accounting statement after time has passed and to develop a "should-have-been" accounting statement as of a given accounting date. This, however, is rarely done. If it is done, then the reserve strengthening or reserve weakening for given accounting year could be restated. However, the measurement of reserve strengthening does not depend on a restated accounting statement. It is often measured with original accounting statement published at the beginning of the accounting year and at the end of the accounting year.

8 "Report on Reserve Strengthening" by Irene Bass, December 9, 1994, hereinafter "the Bass Report."

9 See page 30 of the Bass report.

10 See page 14 of the Bass Report.

11 *Id.*

12 See, for example, *Intermediate Accounting* note 2, *supra.*

impact on the income statement includes changes in reserve levels from prior accident years for whatever reason. That impact is measured as the difference between calendar year incurred losses and accident year incurred losses.

In my example given above, Irene Bass would not say there was reserve strengthening during 1993 if there was no "one-time (or, at least, unusual and non-periodic), significant change in the and/or methodologies used to compute the reserves which results in a material change to the relative level of adequacy of the total reserve inventory."[13] Even so, the reevaluation of the reserves for older claims at the end of 1993 resulted in a 10% reduction ($300,000) in statutory income. My definition would recognize this impact. Hers would not.

In her own examples, Irene Bass describes several legitimate, but specialized uses of the term "reserve strengthening."[14] In Exhibit 1, Irene Bass describes an example of a change in the actual-to-required ratio of loss reserves for accident years 1985 and prior, as of the end of 1985, and, again, as of the end of 1986. In this example, the absolute dollar value of reserves has gone up, but the ratio of actual-to-required reserves for accident year 1985 and prior has gone down. In this example, the IRS (and some financial analysts) would say there has been reserve strengthening, but Irene Bass would not.

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[13] See note 9, *supra*.

[14] They are illustrated in exhibits 1 and 2 of the Bass report.

The IRS and (most actuaries) would say there has been reserve strengthening in Exhibit 1 because the calendar year incurred losses in 1986 ($860) are greater than the reported accident year incurred losses ($850). Irene Bass claims that these reserves were not strengthened because the actual-to-required ratio (using her terms) went down. This "fact" could not be discovered, however, until the actual was know, i.e., until *all* claims occurring before December 31, 1986 were finally settled. Irene Bass seems to be arguing that reserve strengthening must be measured against reserve adequacy. This argument is also given by James Mac Ginnitie. It does not coincide with the definition which Irene Bass chooses to articulate in her report.

In Exhibit 2, Irene Bass describes another legitimate, but specialized definition of reserve strengthening. Financial analysts are often concerned with the solvency of insurers. Solvency measurement is the measurement of a company's ability to withstand adverse results without becoming insolvent. Solvency is often measured as the ratio of written premiums-to-surplus or earned premiums-to-reserves. In Exhibit 2, the earned premiums-to-surplus ratio increased, leading her to say financial analysts would call it reserve strengthening.

Irene Bass's Exhibit 2 argues against her, not for her. Actuaries (not just analysts) also perform analyses of the financial strength of a p/c insurer. In performing this task, actuaries may call improvements of the premium-to-reserves ratio "reserve strengthening." Irene Bass's use of the term "reserve strengthening," like the financial analyst's use, is legitimate and useful, but not common to most actuaries for the majority of their work.

Irene Bass's Exhibit 3 is an example where reserve strengthening *does* happen in the broad sense. The link ratio in this example is extending, causing a reevaluation of the ultimate incurred losses from older accident years. In this case, the calendar year incurred losses are greater than the accident incurred losses, and the cause if a reevaluation of the cost of older accidents.

Actuaries working in financial analysis, ratemaking, and reserve analysis all have a need to define and measure the impact of reserve changes on calendar year incurred losses. Most would find Irene Bass's definition too restrictive as it stands in relation to the common definition of "reserve strengthening," the same way that other specialized uses stand in relation to it. Hers is not the common actuarial definition of the term.

REPORT OF W. JAMES MAC GINNITIE, F.C.A.S., F.S.A.

As I have stated, Irene Bass has given her own definition of reserve strengthening, one that is clear and well-reasoned, but not synonymous with how the term is used by actuaries evaluating the income of a p/c insurer. James Mac Ginnitie implicitly has given a definition that is less clear and, in my opinion, is a mix of the definition with a change in reserve adequacy. James Mac Ginnitie states in the section of his report[15] labeled "Reserve Strengthening" that:

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[15] See page 7 of the "Expert Opinion Report Prepared by W. James Mac Ginnitie," dated December 14, 1994, hereinafter "the Mac Ginnitie report."

> Property-casualty loss reserves are often referred to as strong or weak in a manner that is synonymous with adequate or inadequate. This means that they are adequate or inadequate to discharge the obligations of the insurer for claims arising from incidents that have already taken place as of the date of the financial statement. In one sense this adequacy can only be tested in retrospect, after all the claims have been settled (and the prospect of an old claim reopening is sufficiently remote).

As stated in my prior report, I believe that the terms "reserve strengthening" and "reserve adequacy" are distinguishable, and that, in discussing an insurer's income, reserve strengthening does *not* mean a change in reserve adequacy. By an "adequate" loss reserve, a p/c actuary means that the loss reserve, established on the books of an insurer as of the accounting date, represents the amount of money required to fully settle claims that have already occurred.

As stated in my report, reserve strengthening is not related to the financial position of a p/c insurer at one time, but, rather to its income. Income represents the change in financial position from one accounting date to another. At a given point in time, a p/c insurer establishes the reserves for the most recent claims and reestablishes the reserves for claims that occurred during prior accounting period. Reserve strengthening has a negative impact on income from the subsequent valuation of these older claims.

The impact of reserve strengthening on underwriting income can be determined by looking at the runoff of

reserves from the beginning of an accounting period to the end of the accounting period. At the beginning of the accounting period there are no reserves for the current accident year, only for prior accident years. Thus, reserve strengthening as it impacts underwriting income is only concerned with the change in reserve adequacy for prior accident years.

My example at page 6 shows the difference between reserve strengthening and a change in reserve adequacy. In that example, reserve adequacy decreased from the end of 1992 to the end of 1993, both in absolute dollars (-$700,000) and relatively (-7.8%). However, this change in reserve adequacy could not be discovered until long after the fact. At the end of 1992, the best estimate of the required reserve ($1,750,000) is the carried reserve ($1,250,000), as long as that carried reserve was estimated using sound actuarial methods and considering all available information. So long as the carried reserve is the best estimate, there should be an *equal* likelihood that the loss liabilities of 12/31/92 will settle for less than $1,250,000 as their ultimate settlement for more than $1,250,000. At the end of 1993, by our best estimate of the loss liabilities established on 12/31/93 have deteriorated and adversely impacted income by $300,000. The carried reserves as of 1993 show this fact. At this time the required reserve is best estimated by the carried reserve.

Reserve strengthening is measured by the carried reserve. Reserve adequacy still must wait for the year 2025. Reserve adequacy can only be measured with hindsight. P/C insurers are supposed to establish the full liabilities for losses at year-end. These liabilities are estimates. Even so, they represent best estimates and are not supposed to be

deliberately understated or overstated. With time, however, the reserves established at a point in time for a particular block of accident year claims may prove to have been overstated or understated at prior accounting dates.

As I started at page 8 of this report, although James Mac Ginnitie states that he agrees with Irene Bass's definition of reserve strengthening, his definition is different from her definition, as I can illustrate using my example in this report. In that example, James Mac Ginnitie would not find reserve strengthening, and neither would Irene Bass. If, however, the carried reserve on 12/31/1993 was greater than the required reserve on 12/31/2025, then James Mac Ginnitie *should* find reserve strengthening, but Irene Bass *might not*. Irene Bass *should not*, unless that change was the result of a one-time, non-periodic change in methodology or assumptions. For example, take the case of a large, late-reported claim that significantly changes the case reserve, so that it was greater than the required reserve. In this situation, James Mac Ginnitie should find reserve strengthening, while Irene Bass should not.

CONCLUSIONS

Irene Bass and James Mac Ginnitie, in their reports to the Tax Court in the Atlantic case, give definitions of reserve strengthening that I may have used myself when engaged in certain infrequently performed specialized tasks. Irene Bass defines the term in a way that I would find useful when opining on an Annual Statement. Her definition could easily find its way into a disclosure statement of mine describing the impact of a material change in reserve methodology. James Mac Ginnitie's definition stresses changes in the

reserve adequacy. I may very well have used his terms at some point in my career, when commenting on the past reserving practices of an insurer. Even so, their definitions would not apply to those tasks of ratemaking, reserving, or product analysis that form the bulk of my work or other p/c actuarial work.

James Mac Ginnitie states, in the Mac Ginnitie report, that he agrees with what Irene Bass calls reserve strengthening, however, his definition of the term differs from her definition. Both James Mac Ginnitie's definition and Irene Bass's definition are understandable to actuaries and useful in some applications, however, they do not agree with each other and each would be used in separate, limited situations. James Mac Ginnitie's definitions can only be applied after a long passage of time. Irene Bass's definition can only be used in loss reserve certification. Neither applies to the evaluation of an insurers income.

In my opinion, "reserve strengthening" is a positive difference between calendar year incurred losses and accident year incurred losses, as these losses are published on the accounting books of an insurer. The common use of this term in the p/c industry is one where this positive difference affects the income of an insurer.

/s/ Raymond S. Nichols 1/11/95
Raymond S. Nichols
Date

RESPONDENT'S EXHIBIT AH
DOCKET NO. 25767-93

Rebuttal Reports

of

Ruth E. Salzmann, F.C.A.S., M.A.A.A.

Respondent's Expert

in

Atlantic Mutual Insurance Co., et. al., Petitioner

v.

Commissioner of Internal Revenue, Respondent

Docket No. 25767-93

United States Tax Court

January 12, 1995

IRENE BASS

Rebuttal Report of

Irene Bass's 12/9/94 Report

There are two areas in Ms. Bass's report that need further examination:

1. *Requirements for Materiality and Non-Periodic Changes*

Ms. Bass's definition of reserve strengthening restricts the use of the term to non-periodic and/or material changes in assumptions/methodologies that produce material changes in the margin of adequacy. I agree that these criteria produce reserve strengthening but not with her conclusion that all reserve strengthening must therefore be material. An analogy of this point: All obese persons are overweight, but not all overweight persons are obese.

On pages 15 and 16 of her report, Ms. Bass supports the requirement of "materiality" by citing references to the Annual Statement Schedule F Interrogatories and to the Annual Statement Instructions relating to actuarial opinions. Stipulations of materiality are common in all financial reports or audits. This does not mean that lesser changes had no impact on financial results; it only means that they need not be *disclosed.* Of further significance in these references is the fact that they only apply to material changes in assumptions/methodologies/etc. In the loss reserving area, it is only when such material changes have been

made that one has sufficient confidence that a material change in the margin of adequacy is likely to occur. This is so because the actual change in the margin of adequacy (the reserve strengthening or weakening) will not be known until all accident-year losses through the statement date have been settled. Thus, the purposes of the references cited by Ms. Bass are for reasons other than to restrict the definition of reserve strengthening.

2. *Quantification of Reserve Strengthening*

Ms. Bass's definition of reserve strengthening requires "a material change in the relative level of adequacy of the total reserve inventory" (page 30). There is no exhibit or discussion, except in general terms, of how this material change would be quantified. Therefore let us look at some of her exhibits/examples:

a. In Exhibit 1 and on pages 42, 43, and 44, Ms. Bass implies that a decrease in the ratios of actual to required reserves is reserve weakening; and an increase, reserve strengthening. This is true most of the time, but not all of the time. See the exhibit below:

Margins of Adequacy

	(1)	(2)	(3)	(4)
		Ultimate	Ratio	Inadequacy
Year-end	Reserve	Developments	(1) - (2)	(2) - (1)
12/31/n-1	$1,500	$1,700	.88	$200
12/31/n	$1,000	$1,170	.855	$170

Though the ratio in column (3) decreased, there was a reserve strengthening of $30. This is so because the inadequacy decreased by that amount. Reserve strengthening is measured in *dollars*. Ratios and percentages, if used, are merely tools to derive the dollars.

b. In Ms. Bass's criticism of the examples of reserve strengthening in the IRS regulation, she rephrases Exhibit 1 on page 36 and seemingly concludes that there is no reserve strengthening because the remaining unpaid 1984 claims "at year end 1986 are identical to what had been held (for them) at year end 1985." It needs to be repeated that reserve strengthening involves the change in the dollar margin of adequacy for *all unpaid claims* as of each inventory date. Because of the one claim that closed in 1986, the 12/31/85 reserves (using her example) were actually $200,000 more inadequate than the 12/31/86 reserves. As a reduction in the margin of inadequacy produces reserve

strengthening, the strengthening in 1986 was $200,000. This measurement would be the result produced by IRS - and, in this case, by myself as well.

c. In Exhibit 1, Ms. Bass states that there has been "no reserve strengthening." True. The IRS, using the data in the exhibit, would produce a reserve strengthening of $10 *as of 12/31/86*. The true result is a reserve weakening of $140,[1] which does not become known *until many years later* after all of the respective losses are settled. (Such ultimate values are set forth in cols. 6 and 14.) All actual calculations of reserve strengthening require fully developed data as illustrated in Exhibit 1, but the time-delay involved is not quite so evident. The question remains: If a timely *measurement* is needed - and a true measurement will not be available for many years - is it acceptable to use an imperfect *measurement* that is consistent with "lay" usage of the term?

/s/ Ruth E. Salzmann
Ruth E. Salzmann

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[1] The inadequacy of 12/31/85 reserves is $60 ($860 - $800), and the inadequacy of 12/31/86 reserves is $200 ($1,210 - $1,010). The change is an increase in the inadequacy, or a reserve weakening, of $140.

RESPONDENT'S EXHIBIT AI
DOCKET NO. 25767-93

Rebuttal Reports

of

Ruth E. Salzmann, F.C.A.S., M.A.A.A.

Respondent's Expert

in

Atlantic Mutual Insurance Co., et. al., Petitioner

v.

Commissioner of Internal Revenue, Respondent

Docket No. 25767-93

United States Tax Court

January 12, 1995

W. JAMES MacGINNITIE

Rebuttal Report of

W. James MacGinnitie's 12/14/94 Report

I do not disagree with Mr. MacGinnitie's general definition and measurement of reserve strengthening (weakening), but I do take exception to some of the specifics in his report.

Regarding Conclusion 1

This conclusion is divided into three parts, the last two pertaining to the "arbitrary limits" imposed by the IRS regulation. My comments on material supporting these conclusions are as follows:

1. In reviewing the criticisms of the "arbitrary limits," one must not overlook the fact that these limits serve as caps on the amount of reserve strengthening. A cap (if applicable) therefore reduces the amount of reserve strengthening, which in turn *increases* the amount of unpaid losses eligible for "fresh start" discounting.

2. The data arrangements used by the IRS to calculate reserve strengthening may be arbitrary to some, but they are the "data arrangements" set forth in the statutory annual statement, which is a common format applicable to all P/C insurers. Therefore, it is reasonable, in my opinion, to use annual statement detail even though some insurers may have a more refined data arrangement available. What a Pandora's box would be opened if a common published format were not prescribed!

3. Another of Mr. MacGinnitie's criticisms states that strengthening, as measured by the IRS, is arbitrary because it depends upon when the claim is settled, or when payments are made. This criticism is illustrated in Exhibit 2.[1] This criticism can be answered by noted that when the IRS calculates its "fresh start," the discount is allowed on 12/31/86 reserves, reduced by the adverse developments of the 12/31/85 reserves, reported through 12/31/86. These adverse developments are the "reserve strengthening" as defined by the IRS. If, as the criticism implies, these unfavorable developments were not limited to the amount of the respective 12/31/86 reserve, the subtraction thereof would produce a *negative* reserve for that category. Would it make sense to calculate a discounted value for a negative reserve?

4. Example 4 is presented in Mr. MacGinnitie's report to show the "anomaly in the IRS test, that consistently under-reserved insurers will always manifest 'strengthening' . . ." This statement is generally true, but not "always." A company can be under-reserved and still report favorable developments (an adequacy) in the first twelve months, but not when fully developed.[2] In this case, there would be no reserve strengthening as defined by the IRS.

5. In Example 3, Mr. MacGinnitie illustrates how external developments, beyond the insurer's control (in this case the insolvency of the company's reinsurer), can produce "strengthening" under the IRS test. I would argue that loss reserves are subject to *all future contingent* developments; and for this reason, all developments should be included in retrospective tests as well as in the measurements of strengthening. It is to be remembered that such adverse developments are limited in the IRS test to those that develop in the subsequent twelve months.

Regarding Conclusion 2

Mr. MacGinnitie concludes that rather than a reserve strengthening of $6.5 million in 1986 as calculated by the IRS for Atlantic Mutual, the "actual" result was a reserve weakening of $4.2 million. The $4.2 million was derived from retrospective tests of the 12/31/85 and 86 reserves with developments through 12/31/93. In this calculation, the indicated inadequacy of the 12/31/86 reserve exceeded the indicated inadequacy of the 12/31/85 reserve by $4.2 million. When there is an increase in the inadequacy dollars, there is reserve weakening in that accounting period, as Mr. MacGinnitie noted in his conclusion.

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[1] Example 2 has an arithmetic error. The reserve strengthening, calculated in the last column for Case 2, should be $1,000,000 instead of the $1,500,000 shown. This correction, however, does not change the thrust of the criticism.

[2] A study of Schedule P results for individual companies will quite often show favorable developments after twelve months that subsequently revert to an unfavorable status as the larger and more complicated claims are settled.

Note that I used the adjective, indicated, to describe the calculated inadequacies. This modifier is necessary because the data involved still include estimates for the unpaid amounts on claims not yet settled. These estimates accounted for 12.7% of the 12/31/86 developed dollars and 11.2% of the 12/31/85 developed dollars. Mr. MacGinnitie assumes that these estimates are "accurate and that future developments will be small." This may be a doubtful assumption for two reasons:

1. the company's history of inadequate reserve levels, and

2. the higher unpaid loss percentages existing in the P/C industry at approximately similar stages of development.[3] (see Appendix I)

To the extent that Mr. MacGinnitie's assumption is not correct, a "fairer" comparison of the respective reserve inadequacies would have resulted if the calculation had included the same period of development (in years) for both reserve dates.

Perhaps the more important issue that can be derived from Mr. MacGinnitie's analysis is this: If it takes seven years to produce a reasonable approximation of the reserve

[3] The exhibit in this Appendix shows the magnitude of unpaid loss levels after six years of development. Although six years is one and two years shorter than the development periods used in Mr. MacGinnitie's calculation, the reserve date of 12/31/76 is also earlier (when tails were shorter). It is the general magnitude of unpaid levels in developed data that is of concern here, not the precise comparability of the data.

strengthening (weakening) that occurred in a specific calendar year, what does one do when a timely quantification is needed? And if this need exists, is it justifiable to use an imperfect measurement that is consistent with a common usage of the term?

/s/ Ruth E. Salzmann

Ruth E. Salzmann

Appendix 1

96 Estimated Liabilities for Losses
* 1988 Revision

Prospective Evaluations

As mentioned earlier in "Retrospective Tests," a complete review of prior liability levels requires a prospective evaluation of the remaining unpaid amounts in the developed-to-date liabilities. Such remaining amounts are likely to be substantial. The following exhibit illustrates
* the level of unpaid remainders after six years for eight insurers.

Unpaid Status of Developed Liabilities
After Six Years

Group	% Unpaid	Group	% Unpaid
AEtna Life	31.8	Pru-Pac (Co.)	27.8
CNA	30.0	St. Paul	27.5
Liberty	26.4	State Farm (2 Cos.)	5.1
Nationwide (2 Cos.)	7.5	Travelers	29.3

Although percentages can vary from insurer to insurer because of different levels of adequacy in the remaining unpaid portions, this effect has been neutralized to a great extent by using liabilities

* developed through ten years.* Different claim-settlement practices may also contribute to the variations, but the primary cause of variation is the differences in mix of business underwritten by insurers. The exhibit points out the continuing significance of unpaid dollars in developed liabilities.

* [39] These percentages are complements of the quotients of paid developments through
* six years divided by 12/31/76 liabilities developed through ten years, or 12/31/86.

Source: "Property-Liability Insurance Accounting", IASA, 1988 Revision; Chapter 4, "Estimated Liabilities for Losses and Loss Adjustment Expenses" authored by Ruth E. Salzmann, p. 96.

(5)

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No. 97-147

In the
Supreme Court of the United States
October Term, 1997

ATLANTIC MUTUAL INSURANCE CO. AND
INCLUDIBLE SUBSIDIARIES,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari
To The United States Court of Appeals
For The Third Circuit

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QUESTION PRESENTED

Whether petitioner engaged in "reserve strengthening" in 1986 within the meaning of section 1023(e)(3)(B) of the Tax Reform Act of 1986, as determined by respondent under a Treasury regulation that petitioner contends is invalid.

PARTIES TO THE PROCEEDING

All the parties are named in the caption.

STATEMENT PURSUANT TO RULE 29.6

There are no parent or subsidiary companies to be listed under the provisions of Rule 29.6.

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No. 97-147

In the
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ATLANTIC MUTUAL INSURANCE CO. AND INCLUDIBLE SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
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On Writ of Certiorari
To The United States Court of Appeals
For the Third Circuit

OPINIONS BELOW

The opinion of the Third Circuit is reported at 111 F.3d 1056 and is set forth in its entirety in the Appendix to the Petition for Writ of Certiorari at A-1. The opinion of the Tax Court, reversed by the Third Circuit, is unofficially reported at 71 T.C.M. (CCH) 2154 and is set forth in its entirety in the Appendix to the Petition for Writ of Certiorari at A-26.

JURISDICTION

The decision below was issued by the Third Circuit on April 24, 1997 and judgment was entered on that date. Petitioner herein, Atlantic Mutual Insurance Company (hereinafter "Atlantic") and Includible Subsidiaries, did not

file a petition for rehearing in the Third Circuit. In accordance with 28 U.S.C. § 2101(c), a Petition for Writ of Certiorari was filed on July 22, 1997 and was granted on October 20, 1997. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant portions of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023, 100 Stat. 2085, 2404 (1986); of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 216, 98 Stat. 494, 758 (1984); and of Treas. Reg. § 1.846-3(c) (1992), are set forth in the Appendix to the Petition for Writ of Certiorari at A-48, A-50, and A-52, respectively.

STATEMENT OF THE CASE

A. *The Statute and the Treasury Department Regulations.*

1. *The Statute.*

The question in this case involves the meaning of the term "reserve strengthening" in section 1023(e)(3)(B) of the Tax Reform Act of 1986 (the "1986 Act").

In 1986, Congress changed the way in which insurance companies compute reserves for unpaid losses and loss adjustment expenses arising under insurance and reinsurance policies ("loss reserves") for federal income tax purposes. Before the 1986 Act, insurers were allowed to

reduce income each year by the amount of their "losses incurred," which were defined as losses paid plus (minus) the increase (decrease) during the year in undiscounted loss reserves. Section 1023 of the 1986 Act required loss reserves to be discounted to present value for purposes of determining losses incurred beginning in 1987. Under section 1023 of the 1986 Act, for purposes of computing the annual change in its loss reserves for its 1987 tax year, an insurer was required to discount both year-end 1987 loss reserves and year-end 1986 loss reserves.

In the absence of a special transition provision, the difference between the undiscounted and discounted year-end 1986 loss reserves would have been includible in taxable income. I.R.C. §§ 481, 807(f) (1986). Section 1023(e) of the 1986 Act, however, provided a "fresh start" under which that difference was permanently excluded from taxable income for all purposes of the Internal Revenue Code of 1986 (the "Code").

Because Congress was concerned about the potential for abuse of the "fresh start" provision, Congress provided that the amount of the discount on any loss reserve increase in 1986 attributable to "reserve strengthening" would be eliminated from the "fresh start" and treated as an increase in 1987 taxable income. To that effect, section 1023(e)(3)(B) of the 1986 Act provides as follows:

> RESERVE STRENGTHENING IN YEARS AFTER 1985. -- [The fresh start] shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as

occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

Section 1023(e)(3) of the 1986 Act was patterned after virtually identical "fresh start" and "reserve strengthening" rules contained in section 216(b) of the Deficit Reduction Act of 1984 (the "1984 Act"), which contained provisions changing the way in which insurance companies compute life insurance reserves ("life reserves") for federal income tax purposes. *See infra* pp. 19-20.

2. *The Regulations.*

On September 4, 1992, the Treasury Department issued a sweeping regulatory interpretation of the term "reserve strengthening" for purposes of section 1023 of the 1986 Act. T.D. 8433, 1992-2 C.B. 146. According to those interpretive regulations, the amount of "reserve strengthening" under the 1986 Act is the amount (as computed under paragraphs (2) and (3) of section 1.846-3(c)) that is determined to have been "added" to a loss reserve during 1986.[1] For loss reserves at year-end 1986 in respect of losses that occurred in 1985 and prior years ("pre-1986 accident years"), those regulations include a so-called

[1] For purposes of section 1.846-3(c) of the Treasury Department regulations, a loss reserve is defined as the aggregate of the unpaid loss estimates for losses incurred in an accident year of a line of business. An "accident year" is the year of the occurrence of an event specified in an insurance policy that triggers the insurer's liability for resulting losses. I.R.C. § 846(f)(1) (1986). A "line of business" refers to a group of insurance policies covering similar risks and for which a separate category exists for reporting loss payment patterns. I.R.C. § 846(f)(4) (1986).

"mechanical test" for "reserve strengthening." Under that test, if a loss reserve at December 31, 1986 for a pre-1986 accident year exceeded the amount of the loss reserve at December 31, 1985 less the amounts paid in 1986 on that loss reserve, the excess automatically is deemed "reserve strengthening" up to the amount of the 1986 loss reserve.[2] The excess is so deemed under the mechanical test even when there is, in fact, no increase in the amount of the 1986 loss reserve over the amount of the 1985 loss reserve.[3] Treas. Reg. § 1.846-3(c)(1) and (3) (hereinafter sometimes referred to as the "regulation").

In short, the regulation sweeps into the definition of "reserve strengthening" *all* 1986 increases in a loss reserve in respect of pre-1986 accident years, plus certain increases in pre-1986 losses incurred even when a loss reserve did not increase. The regulation thus applies the "reserve strengthening" definition without regard to whether such

[2] The regulation provides two narrow exceptions from this rule, neither of which is applicable in this case. Treas. Reg. § 1.846-3(c)(3)(ii).

[3] The Tax Court's opinion in *Western National Mutual Ins. Co. v. Commissioner* contains an example in which the regulation would find "reserve strengthening" when there has been no increase in a loss reserve. 102 T.C. 338, 349 n.8 (1994). *See infra* pp. 46-47. For simplicity, Atlantic hereinafter sometimes describes the effect of the mechanical test in the regulation as including "any increase" or "all increases" in loss reserves for pre-1986 accident years, even though the regulation treats as "reserve strengthening" some situations in which a loss reserve was not in fact increased.

increases resulted from changes in the insurer's reserving assumptions or methodologies.[4]

B. *Western National Mutual Ins. Co. v. Commissioner.*

The first case that addressed the definition of the term "reserve strengthening" as used in section 1023 of the 1986 Act was *Western National Mutual Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd*, 65 F.3d 90 (8th Cir. 1995), In *Western National*, the taxpayer, which had not changed its assumptions or methodologies in calculating its year-end 1986 loss reserves, challenged the validity of the regulation regarding "reserve strengthening." The taxpayer introduced into evidence the reports of two highly qualified property and casualty insurance experts regarding the meaning of the term "reserve strengthening" as used in the property and casualty insurance business. In general, those experts testified that the characteristics of "reserve strengthening" include changes in assumptions or methodologies. Respondent did not submit any expert testimony. Respondent claimed that congressional intent, as expressed in the Conference Committee report accompanying the 1986 Act (the "Conference Report") supported the regulation.

[4] While the regulation defines "reserve strengthening" in an all-encompassing manner for pre-1986 accident year losses, section 1.846-3(c)(2) of the Treasury Department regulations limits the amount of "reserve strengthening" with respect to the 1986 accident year to the portion of a loss reserve for the 1986 accident year attributable to *changes in assumptions* that were used to determine loss reserves for the same line of business for the 1985 accident year.

The Tax Court concluded that, if Congress intended to exclude *all* 1986 additions to loss reserves from the application of the "fresh start" provision, as provided in the regulation, Congress would have included in the statute that straightforward rule, rather than a term of art used in an unconditional manner. 102 T.C. at 355. The Tax Court further concluded that Congress intended the term "reserve strengthening" in the 1986 Act to be interpreted in a manner consistent with the undisputed meaning of the same term in the 1984 Act (which was consistent with its insurance industry meaning). *Id.* at 354, 360. The Tax Court therefore determined that the regulation was contrary to the unambiguous meaning of the term "reserve strengthening" as used in the statute. As a consequence, the Tax Court held the regulation to be "invalid to the extent that it defined all additions to reserves as reserve strengthening." *Id.* at 361.

On appeal, the United States Court of Appeals for the Eighth Circuit affirmed the holding of the Tax Court. The court stated that the provision in question was not drafted with the lay reader in mind and that there was "no statutory basis for the Commissioner's present attempt to make reserve strengthening mean one thing in the life insurance industry but another in the property and casualty industry." *Western National*, 65 F.3d at 93. The court went on to say that "[e]ven if there were no property and casualty industry definition of reserve strengthening, . . . we see nothing that would prohibit Congress from appropriating the life insurance standard and applying it to a property and casualty provision of the Code." *Id.* The Eighth Circuit held that Congress intended to deny "fresh start" only to increases in loss reserves caused by changes in assumptions or

methodologies and that "the regulation cannot be sustained." *Id.* at 93-94.

C. *The Facts of This Case.*

This case was submitted to the Tax Court as a fully stipulated case under Rule 122 of the Tax Court Rules of Practice and Procedure. Aside from the content of expert reports, the parties agreed to all of the relevant facts.

Atlantic, a property and casualty insurance company, is taxable as an insurance company under Parts II and III of Subchapter L of Chapter 1 of Subtitle A ("Subchapter L") of the Code. Atlantic is the common parent of affiliated corporations which filed a consolidated return. (Jt. App. at 23-24, Stip. ¶¶ 1, 3.)[5] Centennial Insurance Co. ("Centennial"), a property and casualty insurer wholly owned by Atlantic, was included in Atlantic's consolidated return. (Jt. App. at 24, Stip. ¶ 5.) (Hereinafter, references to Atlantic include Centennial where appropriate and the Atlantic affiliated group where appropriate.) For regulatory and tax purposes, Atlantic was required to estimate, as of the end of each year, the amount of losses and loss adjustment expenses it ultimately would pay on losses that had occurred by the end of the year. (Jt. App. at 29, Stip. ¶ 14.) Those loss reserves were reasonable in amount at the end of 1985 and at the end of 1986. (Jt. App. at 38, Stip. ¶ 39.)

[5] The Joint Appendix filed with this brief is cited herein as Jt. App. at ___. The Stipulations of Fact filed with the Tax Court are included in the Joint Appendix at pp. 22-48 and are cited herein as Stip. ¶ ___.

On a hindsight basis, Atlantic's aggregate 1985 and 1986 loss reserves were inadequate to discharge the liabilities covered by such reserves. Its aggregate 1986 loss reserves were more inadequate than its aggregate 1985 loss reserves. (Jt. App. at 32-33, Stip. ¶ 24.) Atlantic did not increase its loss reserves for 1985 and prior accident years included in its aggregate loss reserves at year-end 1986 for tax-motivated reasons. (Jt. App. at 39, Stip. ¶ 41.) Atlantic computed its December 31, 1986 loss reserves using the same assumptions and methodologies used in determining its loss reserves as of December 31, 1985. (Jt. App. at 37-38, Stip. ¶ 38.) In its tax return for 1987, Atlantic included the entire difference between its undiscounted and discounted loss reserves at December 31, 1986 in the "fresh start" allowed by the 1986 Act. (Jt. App. at 24-25, Stip. ¶ 6.)

Using the mechanical test of the regulation, respondent determined that a portion of Atlantic's year-end 1986 loss reserves for pre-1986 accident years resulted from "reserve strengthening." That amount was determined in general by subtracting from Atlantic's year-end 1986 loss reserves for pre-1986 accident years the amount of its loss reserves at year-end 1985 less payments made in respect of such loss reserves during 1986. (Jt. App. at 24-27, Stip. ¶¶ 6, 7, 8, 9.) Based on that determination, respondent issued a statutory notice of deficiency for 1987 to Atlantic.

D. *Proceedings Below.*

Atlantic petitioned the Tax Court for redetermination of the 1987 deficiency pursuant to sections 6213(a) and 7442 of the Code.

Atlantic entered into evidence the reports of Irene Bass and James MacGinnitie, two experts who testified in *Western National*. Irene Bass opined that, in the property and casualty insurance business, "reserve strengthening" involves changes in assumptions or methodologies used to compute loss reserves that result in a material change in the level of adequacy of those reserves. (Jt. App. at 73.) James MacGinnitie concurred with Irene Bass. (Jt. App. at 98.)

Respondent entered into evidence the reports and rebuttal reports of two experts indicating that the term "reserve strengthening" in property and casualty insurance is used in more than one manner. Both of respondent's experts acknowledged that the term is used in property and casualty insurance to mean increases in reserves involving changes in assumptions or methodologies, as Atlantic's experts stated. (Jt. App. at 184, 200, 202.) However, respondent's experts each expressed different views regarding other uses of the term.

Finding the case before it factually indistinguishable from *Western National*, the Tax Court held that Atlantic had not engaged in "reserve strengthening" within the meaning of section 1023(e)(3)(B) of the 1986 Act. 71 T.C.M. (CCH) 2154, 2159-60 (1996). Respondent appealed the Tax Court's decision to the Court of Appeals for the Third Circuit. In a decision entered April 24, 1997, the Third Circuit reversed the decision of the Tax Court, and in so doing, it expressly refused to follow the decision of the Eighth Circuit in *Western National* holding that the meaning of "reserve strengthening" in the 1986 Act is plain. 111 F.3d 1056, 1061 n.7 (1997).

SUMMARY OF ARGUMENT

This case involves the validity of a Treasury regulation that interprets the term "reserve strengthening" as used in the 1986 Act. Atlantic contends that the regulation does not properly interpret the statutory term.

The overriding consideration in the interpretation of any statutory term is its plain meaning. The plain meaning of "reserve strengthening" in the 1986 Act can be determined by looking to its established meaning in insurance tax precedents and the undisputed meaning of the term as used in the 1984 Act.

For decades, the term "reserve strengthening" in insurance taxation consistently has been used in Treasury Department regulations, Internal Revenue Service rulings, and judicial decisions to mean increases in reserves involving changes in assumptions or methodologies. It is undisputed that the definition of "reserve strengthening" as used in the 1984 Act was consistent with the established insurance tax meaning. The identity between the language and context of the "reserve strengthening" provisions of the 1984 Act and of the 1986 Act leads to the conclusion that the plain meaning of the term "reserve strengthening" in the 1986 Act is the established tax meaning of the term, *i.e.*, reserve increases involving changes in assumptions or methodologies.

Contrary to the holding of the Eighth Circuit in *Western National*, the Third Circuit concluded that the term "reserve strengthening" did not have a plain meaning, and that, based on the legislative history, the regulation was a

valid interpretation of the statutory language. In reaching its conclusion, the Third Circuit relied on the lack of a statutory definition of "reserve strengthening," the expert testimony, a perceived difference between life reserves and loss reserves, and a change in the statutory language to show that "reserve strengthening" does not have a plain meaning. Each of the Third Circuit's reasons is without merit.

It is clear from this Court's precedents that the term "reserve strengthening" in the 1986 Act takes meaning from the established use of the term and the structure and context of the statute, making a statutory definition unnecessary to finding the plain meaning of the term. Further, the expert testimony in this case cannot negate that plain meaning in insurance taxation. Moreover, the Third Circuit's assertions regarding the differences between life reserves and loss reserves are misplaced. The Third Circuit's assertions regarding the absence of assumptions and methodologies in computing loss reserves makes no sense. Even the government's experts recognized that changes in assumptions or methodologies used in computing loss reserves occur and can give rise to "reserve strengthening." Finally, the Third Circuit incorrectly interpreted a difference in the statutory language between the 1984 Act and the 1986 Act to establish the absence of a plain meaning of "reserve strengthening" in the 1986 Act. The statutory difference in question had no impact whatever on the general definition of the term "reserve strengthening."

Once the Third Circuit's missteps are recognized, it is clear that the plain meaning of "reserve strengthening" in the 1986 Act is increases in reserves involving changes in assumptions or methodologies. Thus, the regulation is

invalid to the extent it leads to the result that Atlantic, which did not change its assumptions or methodologies in establishing its 1986 loss reserves, engaged in "reserve strengthening."

Further, the Third Circuit failed to recognize that, even if "reserve strengthening" as used in the 1986 Act did not have a plain meaning, the regulation would be invalid because it does not limit "reserve strengthening" to "artificial" increases in reserves as described in the legislative history of the 1986 Act and because it reaches even beyond respondent's explanation of congressional intent.

ARGUMENT

I.

The regulation cannot be valid if it is contrary to the plain meaning of the term "reserve strengthening" as Congress used it in section 1023(e)(3)(B) of the 1986 Act.

In its decision below, the Third Circuit stated that its inquiry into the validity of the Treasury Department's interpretation of the term "reserve strengthening" as used in the 1986 Act was controlled by the principles of *Chevron U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). In articulating the *Chevron* principles, the court noted: "Initially, we must determine whether the meaning of 'reserve strengthening' is clear from the plain language of section 1023(e)(3)(B)." *Atlantic Mutual*, 111 F.3d at 1059. If the Treasury Department's interpretation

of the term conflicts with that plain language, the interpretation is invalid. *See, e.g.*, *Brown v. Gardner*, 513 U.S. ___, 115 S. Ct. 552, 556 (1994).

This Court has held repeatedly that if the plain meaning of a term can be discerned from an analysis of the text of the statute, the analysis is complete. *See, e.g.*, *id.*; *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 475 (1992); *Demarest v. Manspeaker*, 498 U.S. 184, 190 (1991). To determine the plain meaning of statutory language, this Court has looked to the text of the statute, the structure of the statutory scheme as a whole, the context of the statute (including the text of related statutes and the established usage of statutory terms), and canons of statutory construction. *See, e.g.*, *Commissioner v. Lundy*, 516 U.S. ___, 116 S. Ct. 647, 655 (1996); *Gardner*, 513 U.S. at ___, 115 S. Ct. at 555; *Commissioner v. Keystone Consolidated Industries, Inc.*, 508 U.S. 152, 159 (1993).

As the Third Circuit implicitly recognized in this case, only if the statute is not plain should legislative history be relevant to the inquiry. *Atlantic Mutual*, 111 F.3d at 1062. Legislative history should not be relevant to the determination of a statute's plain meaning because "it is the statute, and not the Committee Report, which is the authoritative expression of the law." *City of Chicago v. Environmental Defense Fund*, 511 U.S. 328, 337 (1994); *see also Davis v. Michigan Dept. of Treasury*, 489 U.S. 803, 808-09 n.3 (1988) (citing *United Air Lines, Inc. v. McMann*, 434 U.S. 192, 199 (1977)).

As shown below, the plain meaning of the term "reserve strengthening" in section 1023(e)(3)(B) of the 1986

Act can be determined from an interpretation of the statutory text in accordance with the established meaning of the term and Congress' use of the same term in virtually identical circumstances in the 1984 Act. *See Lundy*, 516 U.S. at ___, 116 S. Ct. at 655; *Gardner*, 513 U.S. at ___, 115 S. Ct. at 555; *Keystone*, 508 U.S. at 158-59; *see also Rowan Companies, Inc. v. United States*, 452 U.S. 247 (1981).

II.
The plain meaning of the term "reserve strengthening" as used in the 1986 Act can be discerned from the term's established meaning and the prior use of the identical term in an analogous statute.

A. The term "reserve strengthening" consistently has been used in insurance tax precedents to mean increases in reserves involving changes in assumptions or methodologies.

In Treasury Department regulations, Internal Revenue Service rulings, and judicial decisions involving the taxation of insurance companies, both property and casualty and life, the term "reserve strengthening" has been used, without exception, to mean those reserve increases involving changes in assumptions or methodologies.

The term "reserve strengthening" as used in the insurance tax law has its roots in the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 (1959) (the "1959 Act"). Before the 1959 Act, life insurance companies were taxed only on net investment income. The 1959 Act expanded the tax base to include

underwriting income. In determining underwriting income under the 1959 Act, life insurance companies were allowed a deduction for annual increases in insurance policy reserves.[6] I.R.C. §§ 809(b) and (d)(2) and 810(b) and (c) (1954).

Congress recognized, however, that if a company strengthened its insurance policy reserves, which were now tax deductible, the company could distort its reserve deduction in computing its underwriting income. Congress enacted section 810(d)[7] (the predecessor to section 807(f) of the 1986 Code) to spread over time the tax deduction for increases in reserves attributable to "reserve strengthening." *See National Life and Accident Ins. Co.*, 524 F.2d 559, 560 (6th Cir. 1975). In implementing the provisions of section 810(d), the Treasury Department regulations provide extensive rules that differentiate between the treatment of normal annual reserve increases, which are deductible in their entirety in the year of increase, and increases attributable to changes in the basis of computing reserves (*i.e.*, "reserve strengthening"). *See, e.g.*, Treas. Reg.

[6] For this purpose, tax deductible insurance policy reserves included (1) life reserves, (2) unearned premium reserves and loss reserves, (3) policy obligations under insurance and annuity contracts not involving life, health, or accident contingencies, (4) certain dividend accumulations under insurance and annuity contracts, (5) advance premiums, and (6) certain retired lives and premium stabilization reserves under group insurance contracts. I.R.C. § 810(c) (1954).

[7] All section references in this Section II. A. are to the Internal Revenue Code of 1954, unless otherwise indicated.

§ 1.810-3(b) *Examples 1 and 2* (1961); Treas. Reg. § 1.810-3(f) *Example 3* (1961).[8]

The Internal Revenue Service, in applying the above statutory and regulatory provisions over the years, uniformly has used the term "reserve strengthening" to mean increases in reserves involving changes in assumptions or methodologies. *E.g.*, Rev. Rul. 79-395, 1979-2 C.B. 263 (involving a life insurance company that strengthened certain of its life reserves by changing its reserve computation method from the preliminary term basis to the net level premium basis); Rev. Rul. 70-192, 1970-1 C.B. 153 (involving a life insurance company that strengthened its reserves by changing to the assumption that death benefits are paid at the middle of the policy year rather than the end of the policy year); Rev. Rul. 65-240, 1965-2 C.B. 236 (involving a property and casualty insurance company that strengthened its life reserves on guaranteed renewable health policies by changing the basis of computing such reserves from the preliminary term basis to the net level premium

[8] The Treasury Department regulations use the terms "change in basis" and "reserve strengthening" interchangeably to mean reserve increases involving changes in assumptions or methodologies. *See, e.g.*, Treas. Reg. § 1.810-3(a). As the Tax Court in *Western National* stated:

> The phrase "change in the basis of computing such reserves" also appeared in sec. 818(c) [of the 1954 Internal Revenue Code], where "basis" has been interpreted to mean "method". *Reserve Life Ins. Co. v. United States*, 229 Ct. Cl. 529, 640 F.2d 368, 377 (1981).

102 T.C. at 353, n. 14.

basis); and Rev. Rul. 65-233, 1965-2 C.B. 228 (holding that "reserve strengthening" took place in 1959 when the insurance company took "all necessary steps to change the reserve basis for group annuity reserves and to initiate a program for strengthening reserves on individual contracts" prior to December 31, 1959).

The judicial precedents under Subchapter L of the Code also interpret the term "reserve strengthening" in a uniform manner to mean reserve increases involving changes in assumptions or methodologies. In *National Life and Accident Ins. Co. v. United States*, 381 F. Supp. 1034 (M.D. Tenn. 1974), *aff'd* 524 F.2d 559 (6th Cir. 1975), for example, the insurance company changed its assumption regarding the date when death benefits are deemed paid. The District Court analyzed sections 809 and 810 and recognized a distinction between normal annual reserve increases and "reserve strengthening" increases. *Id.* at 1038. The Sixth Circuit cited with approval the comprehensive opinion written by the District Court. 524 F.2d at 560. *See also, e.g., Jefferson Standard Life Ins. Co. v. United States*, 272 F. Supp. 97 (M.D.N.C. 1967), *aff'd in part, rev'd in part, and remanded*, 408 F.2d 842 (4th Cir. 1969).

The long list of precedents shows that the term "reserve strengthening" consistently has been used for insurance tax purposes to mean increases in reserves involving changes in assumptions or methodologies. Those precedents involve both life insurance companies and property and casualty insurance companies. They also apply to all the reserve items listed in section 810(c) (now section 807(c) of the 1986 Code), including life reserves, loss

reserves, and the other reserve items enumerated in that section.

B. Respondent agrees that the term "reserve strengthening" was used in the 1984 Act to mean increases in reserves involving changes in assumptions or methodologies in accord with its established meaning in the insurance tax precedents.

The 1984 Act significantly changed the way in which insurance companies compute life reserves for federal income tax purposes. As in the case of the 1986 Act change in the computation of loss reserves, the 1984 Act change in the computation of life reserves resulted in a reduction in the amount of reserves for most insurers affected by the change. 1984 Act §§ 201-231. Absent special statutory relief, insurance companies affected by the 1984 Act change in the computation of life reserves would have been required to include in income the difference between their life reserves as of the end of 1983 computed on the pre-existing method and on the method prescribed in the 1984 Act.

To provide relief from the adverse effect of the new reserve computation provisions contained in the 1984 Act, Congress provided a "fresh start" transition rule under which any decrease in an insurer's life reserves that resulted from the amendments made by the 1984 Act would not be treated as a change requiring an adjustment to taxable income.

Recognizing that the "fresh start" provision was subject to abuse, Congress included in the 1984 Act a "reserve strengthening" exception to the "fresh start" relief.

Thus, any "reserve strengthening" "reported for federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984," was excluded from the "fresh start."

There is no question that Congress used the term "reserve strengthening" in the 1984 Act in a manner consistent with its well established insurance tax meaning. In fact, respondent never felt the need to issue any regulatory interpretation of the term "reserve strengthening" in the 1984 Act. Moreover, respondent acknowledged, both in this case and in the *Western National* case, that the term "reserve strengthening" as used in the 1984 Act had the same meaning that, without exception, has been ascribed to it in the insurance tax precedents, *i.e.*, increases in reserves involving changes in assumptions or methodologies. *Atlantic Mutual*, 71 T.C.M. (CCH) at 2159; *Western National*, 102 T.C. at 353.

C. The "reserve strengthening" provision of the 1986 Act is in all relevant respects the same as the "reserve strengthening" provision of the 1984 Act.

1. The general structure and content of the provisions of the 1984 Act and of the 1986 Act.

Both the 1984 Act and the 1986 Act contained provisions that significantly changed the way in which insurers compute their insurance policy reserves. 1984 Act § 211(a); 1986 Act §§ 1023(a)-(d). Both changes involved adjustments which generally resulted in decreases to the

affected reserves for federal income tax purposes.[9] There is an identity between the overall structure and content of the 1984 Act and the 1986 Act reserve computation changes, and, in particular, the use within that structure and content of the identical term "reserve strengthening."

The 1984 Act amended the Internal Revenue Code to provide for a change in the way in which life reserves are computed for federal income tax purposes; the 1986 Act amended the Internal Revenue Code to provide for a change in the way in which loss reserves are computed for federal income tax purposes. Section 216 of the 1984 Act and section 1023(e) of the 1986 Act each addresses three collateral matters with respect to the respective changes in reserve computation rules: (1) each specifies that the respective reserve computation changes apply to total reserves as of the beginning of the first year to which the new rules applied and provides a concomitant transitional rule; (2) each allows a "fresh start" with respect to the transitional rule; and (3) each provides a "reserve strengthening" exception to the "fresh start." Those provisions are addressed in detail below.

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[9] Each set of changes applied equally to companies taxed as life insurance companies under Part I of Subchapter L of the Code and other insurance companies taxed under Part II of Subchapter L. (*See infra* note 11 and accompanying text for a discussion of the relationship between Part I and Part II of Subchapter L.) Sections 211(b)(9) and 216(a)(2) applied the 1984 Act reserve computation changes to life reserves included in a property and casualty insurer's reserves under section 832(b)(4) of the 1954 Code for the first taxable year after 1983. Similarly, sections 1023(b) and (e)(2)(B) applied the 1986 Act reserve computation changes to a life insurer's loss reserves under section 807(c)(2) of the Code for the first taxable year after 1986.

2. The transitional rules.

In enacting new insurance policy reserve computation rules in the 1984 Act and in the 1986 Act, Congress had to decide whether to apply the new rules just to newly established reserves (*i.e.*, for policies issued or losses incurred during the year of change and thereafter) or to existing reserves in addition to newly established reserves. In each case, Congress made the new reserve computation rules applicable to both existing reserves and newly established reserves. As a consequence, a rule was necessary to provide a transition from the old to the new rules for existing reserves. In the case of each statute, Congress adopted comparable transition rules:

> **The 1984 Act.** The transitional rule of the 1984 Act provides that the life reserves carried over from the last preceding taxable year to the first taxable year in which the new reserve computation rules applied must be computed using the new reserve computation rules. 1984 Act § 216(a). The general effect of that transitional rule was to reduce the December 31, 1983 reserve balances carried over to the beginning of 1984 by the amount of the difference between the year-end 1983 life reserves computed under the old and new rules.

> **The 1986 Act.** The transitional rule of the 1986 Act provides that the loss reserves carried over from the last preceding taxable year to the first taxable year in which the new reserve computation rules applied must be computed using the new reserve discounting computation rules. 1986 Act § 1023(e)(2). The general effect of that transitional rule was to reduce the December 31, 1986 reserve balances carried over to the beginning of 1987 by the amount of the difference between the year-end 1986 loss reserves computed on the old undiscounted basis and the new discounted basis.

3. The "fresh start" adjustments.

In the normal course of insurance company accounting for federal income tax purposes, the amount of the reduction in the reserve balances carried over to the new year under the transitional rules of the 1984 Act and the 1986 Act would have been included in income. I.R.C. §§ 481 and 807(f) (1986); I.R.C. § 810(d) (1954). As a policy matter, Congress chose not to require, under either the 1984 Act or the 1986 Act, the income adjustments that would have flowed from the reserve computation changes mandated by the two statutes. The relief from such income adjustments is referred to as the "fresh start." In the case of each statute, Congress adopted comparable "fresh start" provisions:

> **The 1984 Act.** In general, the "fresh start" adjustment of the 1984 Act eliminated the income inclusion by providing that any change in the basis of computing reserves between the end of 1983 and the beginning of 1984 resulting from the 1984 Act was not to be treated as a change in method of accounting (or of computing reserves) for federal income tax purposes. 1984 Act § 216(b)(1).

> **The 1986 Act.** In general, the "fresh start" adjustment of the 1986 Act eliminated the income

inclusion by providing that any change in the amount of loss reserves between the end of 1986 and the beginning of 1987 resulting from the 1986 Act was not to be taken into account for federal income tax purposes. 1986 Act § 1023(e)(3)(A).

4. The "reserve strengthening" exception.

In the case of both the 1984 Act and the 1986 Act, there was a potential for distortion of the "fresh start" provision. Specifically, if an insurance company artificially increased its reserves before the new reserve computation rules took effect, the amount of the "fresh start" would have increased. To prevent such abuse, Congress restricted the application of the "fresh start" under both the 1984 Act and the 1986 Act. Neither the 1984 Act nor the 1986 Act denied the "fresh start" relief *per se* to all reserve increases in the year in which the "fresh start" relief was announced. Instead, the limitation on "fresh start" for reserve increases applied in a more limited way. In the case of each statute, Congress adopted the same general "reserve strengthening" limitation on the "fresh start":

The 1984 Act. In general, the 1984 Act disallowed the "fresh start" with respect to any "reserve strengthening" reported for federal income tax purposes after September 27, 1983 for the 1983 taxable year. 1984 Act § 216(b)(3)(A).

The 1986 Act. In general, the 1986 Act disallowed the "fresh start" with respect to "reserve strengthening" reported for federal income tax

purposes for the 1986 taxable year. 1986 Act § 1023(e)(3)(B).

Based on a comparison of the structure and content of the 1984 Act and the 1986 Act, it is apparent that the term "reserve strengthening" in the 1986 Act was used in the context of the very same type of statutory provision and served the very same purpose as the term "reserve strengthening" in the 1984 Act.

D. The general concept of the insurance policy reserves which were the subject of the "reserve strengthening" provisions of the 1984 Act and of the 1986 Act is the same.

The classic purpose of insurance, whether life insurance or property and casualty insurance, is to pool the probable cost of the same types of risks of loss over a large number of policyholders. *See Helvering v. LeGierse*, 312 U.S. 531 (1941). In line with their loss pooling function, insurance companies issue policies that promise to pay future claims if contingencies specified in the policies occur. In order to provide for the payment of policyholder claims under its policies, an insurance company recognizes a "reserve" liability on its balance sheet for the future payment of claims. National Association of Insurance Commissioners, *Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies* 10-1 (rev. ed. 1996); National Association of Insurance Commissioners, *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies* 10-1 (rev. ed. 1994).

The principal reserves of a life insurance company generally are life reserves and the principal reserves of a property and casualty insurance company generally are loss reserves. A.M. Best Company, *Best's Aggregates and Averages: Life-Health United States* 2 (1997 ed.); A.M. Best Company, *Best's Aggregates and Averages: Property-Casualty United States* 2 (1997 ed.) . The main difference between the insurance policy reserves of life insurance companies and of property and casualty insurance companies is that life reserves are established for the future payment of future policy claims, and loss reserves are established for the future payment of existing policy claims. Treas. Reg. § 1.832-4(b) (1992); *United States v. Atlas Life Ins. Co.*, 381 U.S. 233, 237 n.3 (1965); *Modern Home Life Ins. Co. v. Commissioner*, 54 T.C. 935, 939 (1970). In general terms, however, the insurance policy reserves of all insurers serve a similar purpose. As the Tax Court observed in *Western National*:

> In the insurance industry a policy reserve represents a liability; i.e., it represents an obligation to the policyholders. Historically, reserves have been described in [property and casualty] insurance literature as estimated liabilities for losses and loss adjustment expenses. To some extent, loss reserves are estimates extrapolated from past trends, patterns, averages, and inferences and predictions as to the future. Accordingly, "The reserve simply operates as a charge on so much of an insurance company's assets as must be maintained in order for the company to be able to meet its future commitments under the policies it has issued." The general concept of reserves is the same for life and [property and casualty] insurance companies.

102 T.C. at 350-351 (footnote and citations omitted).

As demonstrated by the foregoing, the "reserve strengthening" provisions of the 1984 Act and of the 1986 Act applied to insurance policy reserves that are the same in general concept.

E. The term "reserve strengthening" is used in property and casualty insurance to refer to an increase in loss reserves involving a change in assumptions or methodologies.

While respondent's experts offered testimony indicating that there are other uses in property and casualty insurance for the term "reserve strengthening," the only use of the term "reserve strengthening" that each expert agreed applies in property and casualty insurance is reserve increases involving changes in assumptions or methodologies. That one definition is consistent with the use of the term "reserve strengthening" in the 1984 Act and with the established insurance tax meaning of the term.

In her expert report, Irene Bass opined that, in the property and casualty insurance business, "reserve strengthening" involves changes in assumptions or methodologies used to compute loss reserves that result in a material change in the level of adequacy of those reserves. (Jt. App. at 74.) In his expert report, James MacGinnitie concurred with the opinion of Irene Bass. (Jt. App. at 98.) Regarding the definition provided by Bass and MacGinnitie,

one of respondent's experts, Raymond Nichols, admitted that it is not wrong, and that it is "understandable to actuaries and useful in some applications." (Jt. App. at 184, 200.) Nichols also opined that Bass' definition is "legitimate and useful" and "clear and well-reasoned." (Jt. App. at 195.) Respondent's other expert, Ruth Salzmann, also agreed that "these criteria [*i.e.*, changes in assumptions or methodologies] produce reserve strengthening . . . ." (Jt. App. at 202.)

F. The plain meaning of "reserve strengthening" in section 1023(e)(3)(B) of the 1986 Act is an increase in loss reserves involving a change in assumptions or methodologies.

As demonstrated above, the plain meaning of the term "reserve strengthening" as used in section 1023(e)(3)(B) of the 1986 Act is an increase in loss reserves involving a change in assumptions or methodologies. That plain meaning can be discerned from the term's longstanding use in insurance tax law and from the term's prior use in a virtually identical provision in the 1984 Act. *See, e.g.*, *Lundy*, 516 U.S. at __, 116 S. Ct. at 655; *Gardner*, 513 U.S. __, 115 S. Ct. at 555.

To suggest Congress would have used in a new manner a term with a decades old meaning in insurance tax law, and one that it had used just two years before in a virtually identical insurance tax provision, is to presume Congress either was deliberately misleading or was careless in drafting an amendment relating to a subchapter of the Code which it has so carefully crafted in the past. Either explanation is "implausible in light of the intricate attention to detail displayed throughout Subchapter L." *Colonial American Life Ins. Co. v. Commissioner*, 491 U.S. 244, 260 (1989); *see also National Life and Accident Ins. Co.*, 381 F. Supp. at 1034 (observing that "Congress was fastidious, not sloppy, in the quality of draftsmanship exhibited in Subchapter L, so as to make decipherable a rather technical portion of the Code.").

This is particularly true when Congress easily could have used, on the face of the 1986 Act, such plain language as "all additions" or "all increases" if it intended to adopt an exception to the "fresh start" consistent with the mechanical test adopted in the regulation rather than one based on "reserve strengthening" as that term is used in insurance tax law. As noted by the Tax Court in *Western National*, "Had Congress intended to exclude any addition to the reserves from the application of the fresh-start provisions as respondent contends, the statute could have included that language." 102 T.C. at 355.

In fact, the meaning of the term "reserve strengthening" is so ingrained in insurance tax law that any effort to redefine the term in the integrated world of Subchapter L inevitably leads to anomalous consequences. For example, as noted above, the 1986 Act loss reserve discounting rules applied to companies taxed as life insurance companies as well as companies taxed as property and casualty insurance companies. *Supra* note 9. At the time that the 1986 Act became law, a life insurance company's change in basis in computing loss reserves was already subject to the "reserve strengthening" provisions of section 807(f) of the 1954 Code (formerly section 810(d) of the 1954 Code). I.R.C. § 807(c) (1954). Moreover, at that

time, the Treasury Department regulations applicable under section 807(f) used the term "reserve strengthening" to mean those increases in reserves involving changes in assumptions or methodologies. Unless the term "reserve strengthening" as used in section 1023 of the 1986 Act is read to mean reserve increases involving changes in assumptions or methodologies (i.e., its established tax meaning), the 1986 loss reserve increases for pre-1986 accident year losses of life insurance companies would be subject to two *different* "reserve strengthening" definitions.

III.
Atlantic did not change its assumptions or methodologies, and the regulation is invalid to the extent it resulted in a determination that Atlantic engaged in "reserve strengthening."

As demonstrated above, the term "reserve strengthening" as used in the 1986 Act has a plain meaning that involves a change in assumptions or methodologies used in determining loss reserves. Respondent stipulated that Atlantic did not change its assumptions or methodologies used to establish its loss reserves at December 31, 1986 from those used to establish its loss reserves at December 31, 1985. (Jt. App. at 37-38, Stip ¶ 38.) By applying the mechanical test of the regulation, respondent determined that Atlantic had made "net additions" to its loss reserves at December 31, 1986 for pre-1986 accident years and that those "net additions" constituted "reserve strengthening." The regulation must be held invalid to the extent it resulted in a determination that Atlantic engaged in "reserve strengthening," because Atlantic did not change the

assumptions or methodologies used in determining its year-end 1986 loss reserves.

IV.
The Third Circuit erred in upholding the validity of the regulation.

A. The Third Circuit erred in concluding that the term "reserve strengthening" did not have a plain meaning in the 1986 Act.

Before reaching to ambiguous legislative history of section 1023(e)(3)(B) to seek a meaning for the term "reserve strengthening," the Third Circuit concluded that there was no plain meaning for the term to be derived from the statute. The Third Circuit listed four reasons for its conclusion, none of which has any merit.

1. The lack of a statutory definition of the term "reserve strengthening."

The Third Circuit began its analysis by noting, "Clearly absent from the text of the statute is any explanation of the meaning of the term 'reserve strengthening.'" 111 F.3d at 1060. The Third Circuit subsequently cited the lack of a statutory definition of the term as one of the reasons for its conclusion "that the meaning of the term 'reserve strengthening' is ambiguous." *Id.* at 1062.

The lack of a statutory definition does not by itself make a term ambiguous. If that were the case, most statutory terms would be considered ambiguous because few statutory terms are defined in the statute. This Court has held that the

structure and context of a statute can give meaning to a statutory term (without the need to turn to the legislative history to find a meaning for the term). *See, e.g.*, cases cited *supra* Part I. The long history of use of the term "reserve strengthening" in insurance tax law and its prior use in virtually identical circumstances in the 1984 Act provided the term with a plain meaning in the 1986 Act. Congress had no more reason to provide an explicit definition of the term in the 1986 Act than it did in the 1984 Act, and the absence of a statutory definition in the 1986 Act therefore does not create ambiguity.

2. The expert testimony.

The Third Circuit pointed to the expert testimony as proof that the term "reserve strengthening" as used in the 1986 Act does not have a plain meaning. 111 F.3d at 1060-62. However, given the structure and context of the 1986 Act and the longstanding tax definition of the term "reserve strengthening," there is ultimately no need for experts to validate the meaning of the statutory term.[10] As the Eighth Circuit stated in *Western National*, "Even if there were no property and casualty industry definition of reserve strengthening . . . , we see nothing that would prohibit

[10] Nor should expert testimony be used to validate a regulation that such testimony does not clearly support. Three of the experts (including one of respondent's experts) agreed that the mechanical test for "reserve strengthening" contained in the regulation is not a correct usage of the term. (Jt. App. at 85, 98-99, 172.) In fact, not only would respondent's expert Ruth Salzmann agree that the regulation is not a correct usage of the term, she apparently would conclude that Atlantic *weakened* its reserves because its aggregate 1986 loss reserves were more inadequate than its aggregate 1985 loss reserves. (Jt. App. at 168.)

Congress from appropriating the life insurance standard and applying it to a property and casualty provision of the Code." 65 F.3d at 93.

The Third Circuit noted, "Indeed, the Tax Court in *Western National* commented that the opinions and testimony of the numerous expert witnesses failed to establish a 'universal and precise definition of reserve strengthening.'" 111 F.3d at 1060-61 (citation omitted). The implication of this comment is that even the Tax Court recognized that the expert testimony demonstrates that the term "reserve strengthening" has no plain meaning in the 1986 Act. However, what the Tax Court concluded in *Western National* was that the term "reserve strengthening" as used in the 1986 Act has a plain meaning consistent with the meaning of the term as used in the 1984 Act. 102 T.C. at 354. With respect to the experts, the court simply observed that the expert testimony "provided sufficient guidance to enable our recognition of the conceptual elements involved in industry jargon." *Western National*, 102 T.C. at 351 n.10.

The Third Circuit also ignored the fact that the expert reports *are not inconsistent* with the long-standing tax definition of the term "reserve strengthening" that is tied to changes in assumptions or methodologies. The Third Circuit's footnote describing the experts highlighted some differences in the definition of "reserve strengthening" provided by the experts, but it failed to note that each of the experts agreed that property and casualty insurance actuaries *do* use the term to mean increases in reserves attributable to changes in assumptions or methodologies. *See supra* Part II.E.

Thus, the Third Circuit was wrong to conclude that the expert reports create ambiguity. Rather, the experts confirm the plain meaning of the term "reserve strengthening" in the 1986 Act derived from the established insurance tax meaning and prior usage of the term.

3. The comparison of life reserves and loss reserves.

The Third Circuit erroneously dismissed the application of the established tax definition of "reserve strengthening" in the context of the 1986 Act by noting distinctions between life reserves and loss reserves. The Third Circuit criticized "[t]he Tax Court's reliance on cases, revenue rulings and legislation involving life insurance reserves" as being "misplaced." 111 F.3d at 1061. In fact, it is the Third Circuit's conclusion that is misplaced.

a. Subchapter L in general.

Initially, the Third Circuit asserted, "For federal income tax purposes, life insurance companies and P & C insurers are taxed in entirely separate manners. Gross income as well as loss reserves are computed on different bases and assumptions." *Id.* This assertion is both irrelevant and incorrect.

There is no reason why any perceived difference in the scheme for taxation of life insurance companies and of property and casualty insurance companies would have any relevance to the interpretation of the term "reserve strengthening." Reserves are clearly common to the taxation of both types of insurance companies, and the general

concepts associated with reserves, such as "reserve strengthening," are common to both. *See supra* Part II.D.

As important, the Third Circuit's assertion regarding the "entirely separate manners" of taxation of life insurance companies and of property and casualty insurance companies is off base. Both life insurance companies and property and casualty insurance companies are taxed under Subchapter L of the Code, and although life insurance companies and property and casualty insurance companies generally are taxed under separate parts of Subchapter L, the basic taxing scheme of the two types of companies is, in all relevant respects, the same. In fact, it should be noted that insurance companies may be licensed to write various types of insurance business and that the test for determining whether an insurer that writes life and non-life business is subject to tax as a life or property and casualty insurer is based on the amount of its life reserves in relation to its total reserves, including loss reserves.[11] I.R.C. § 816(a) (1986).

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[11] Subchapter L of the Code actually is an integrated system for taxing all insurance companies. Each part of Subchapter L incorporates provisions from the other part. Thus, life insurance companies taxed under Part I take into account losses incurred -- a concept found in Part II of Subchapter L -- in computing taxable income, and insurers taxed under Part II take into account changes in any life reserves they hold -- a concept found in Part I of Subchapter L. I.R.C. §§ 805(a), 807(c), and 832(b)(4) (1986). In addition, Subchapter L includes a Part III, Provisions of General Application, which contains provisions that apply *both* to life insurance companies and to property and casualty insurance companies. I.R.C. §§ 841-848 (1986). Significantly, section 846 of the Code, to which the "reserve strengthening" provision in the 1986 Act relates, is included in Part III of Subchapter L.

b. The nature of loss reserves.

Also incorrect was the Third Circuit's conclusion that the definition of "reserve strengthening" as used in the 1984 Act could not logically apply in the property and casualty context because property and casualty insurance loss reserving practices are significantly different from reserving practices for life reserves.[12] The court's statements regarding those perceived differences demonstrate a lack of understanding of loss reserving, and the court's conclusion regarding the applicability of the "reserve strengthening" rule is in any event a nonsequitur. The Third Circuit concluded:

> We find it illogical to apply the life insurance definition of reserve strengthening to P & C insurers -- whose reserves are not predicated upon the same actuarial assumptions. If we did so apply it, arguably there would never be any reserve strengthening in the P & C area since interest rates, mortality assumptions and methodologies are not underlying components of the P & C loss reserves.

111 F.3d at 1061. Even assuming the Third Circuit was correct in its contention that interest rates and mortality assumptions are never used in property and casualty loss

[12] In this connection, the Third Circuit overlooked the fact that loss reserves of companies taxed as life insurance companies already were subject to the established "reserve strengthening" definition. *See supra* pp. 29-30.

reserving,[13] the court was wrong to imply that interest rates and mortality assumptions are the only actuarial assumptions that can have any relevance for purposes of "reserve strengthening."[14] The Third Circuit seemed to recognize that loss reserves are computed based on actuarial assumptions. (The Third Circuit's recognition that actuarial assumptions are used to compute loss reserves is confirmed by section 1.846-3(c)(2) of the Treasury Department regulations which is applicable to the 1986 accident year.) The court simply noted that the assumptions are different from those used to compute life reserves. 111 F.3d at 1061. Of course, to the extent that the Third Circuit recognized that there are assumptions underlying loss reserves, its assertion that the application of the established insurance tax law definition to loss reserves would never produce "reserve strengthening" is self-contradictory.

The Third Circuit went even further afield when it asserted that methodologies are not part of loss reserving. The court described loss reserving as focused on claims

[13] In fact, there are some property and casualty loss reserves that are based in part on interest rate and mortality assumptions. For example, workers' compensation tabular indemnity reserves are "calculated using discounts determined with reference to actuarial tables which incorporate *interest* and contingencies such as *mortality*, remarriage, inflation, or recovery from disability applied to a reasonably determined payment stream." National Association of Insurance Commissioners, *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies* at 10-3 (emphasis added).

[14] As noted *supra* Part II.E., the one use of the term "reserve strengthening" agreed to by all of the experts in property and casualty insurance is increases in loss reserves involving changes in assumptions or methodologies.

experience and judgments of individual claims adjusters and concluded that "methodologies are not underlying components of the P & C loss reserves." *Id.* It should be noted that the Third Circuit's focus on claims and the judgment of claims adjusters has relevance only in the context of case reserves. That description of reserving does not address reserves for incurred but not reported losses and other formula-based reserves. Moreover, two of the experts in this case, including one of the government experts, clearly describe the extensive use of methodologies in setting loss reserves. (Jt. App. at 58-60, 146-50.)

4. The deleted sentence.

The Third Circuit determined that the commonality of structure and language between the 1984 Act and the 1986 Act does not lead to the conclusion that the term "reserve strengthening" should be interpreted consistently. Fundamental to the court's reasoning was that a sentence that was included in the 1984 Act was not included in the 1986 Act. Specifically, the Third Circuit stated:

> [W]e find that the reserve strengthening provision in [the 1984 Act] differs from the provision in [the 1986 Act] . . . . The 1984 statute specifically links reserve strengthening by life insurance companies to changes in the reserve practice used on the most recent annual financial statement. A similar limitation was contained in the Senate amendment to section 1023(e)(3)(B) but was intentionally eliminated by the Conference Committee.

111 F.3d at 1062. Relying on *Russello v. United States*, 464 U.S. 16 (1983), the Third Circuit then adopted the presumption that Congress intended to change the meaning of the term "reserve strengthening" in the 1986 Act by deleting the sentence that contained the limitation. The premise for the Third Circuit's conclusion -- that there was statutory language in the 1984 Act that defined the term "reserve strengthening" -- is flatly wrong.

The sentence in the 1984 Act on which the Third Circuit's conclusion was based is as follows:

> [The reserve strengthening exception] shall not apply to the computation of reserves on any contract issued if such computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which such reserves are set up.

1984 Act § 216(b)(3)(A). The Third Circuit assumed that the above sentence infused the term "reserve strengthening" in the sentence it followed in the statute with a meaning that was tied to changes in assumptions or methodologies, and that by removing the above sentence, the Conference Committee in 1986 changed the definition of the term "reserve strengthening." *Atlantic Mutual*, 111 F.3d at 1062. The Third Circuit failed to give adequate recognition to the established meaning of the term "reserve strengthening." Moreover, it failed to properly interpret the sentence it cited.

As demonstrated at length *supra* Part II.A., the term "reserve strengthening" had an established meaning in

insurance tax law when Congress used it in the 1984 Act. In fact, the House version of the 1984 Act (which preceded the Senate version) contained the "fresh start" rule and the "reserve strengthening" exception, but *not* the sentence in question regarding prior reserve practices. 130 Cong. Rec. H8914 (daily ed. April 11, 1984). This by itself suggests that the sentence regarding reserve practices was not inserted by the Senate to provide a baseline definition of the term "reserve strengthening." Further, a careful reading of the sentence itself actually indicates that its specific purpose was to provide a special rule for contracts that were newly "issued" in 1983.

That *limited* purpose is in fact confirmed by the Senate version of the House Bill, which first included the sentence in question. That version was structured a bit differently than the final 1984 Act. It listed certain exclusions from the general "reserve strengthening" exception in separate paragraphs with *titles*. The title and precise sentence here in question are as follows:

> EXCEPTION FOR COMPUTATION OF RESERVES ON *NEW* CONTRACTS IN CUSTOMARY MANNER. Subparagraph (A)(iii) [the "reserve strengthening" exception] shall not apply to the computation of reserves on any contract issued if such computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which such reserves are set up.

H.R. 4170 (as reported by the Senate Finance Committee), 98th Cong., 2d Sess. § 216(b)(3)(C) (1984) (emphasis added). There is no indication that the deletion of the title in the final version of the 1984 Act was intended to change the Senate "reserve strengthening" rule or the exception therefrom for newly issued contracts contained in the unchanged sentence. It should be clear, therefore, that the sentence for *new* contracts in the 1984 Act cannot properly be alleged to provide a general definition to the term "reserve strengthening" in the statute. Instead, its only purpose was to provide a limited special rule to exclude from the "reserve strengthening" exception to the "fresh start" rule any reserves on new 1983 contracts that were calculated in the same manner as the reserves at year-end 1982 on the same types of contracts.

When the Senate Finance Committee drafted its "reserve strengthening" exception to the 1986 "fresh start" rule, it followed almost precisely the pattern of the "reserve strengthening" language in the 1984 Act, including a sentence immediately after the "reserve strengthening" exception that read: "The preceding sentence [the "reserve strengthening" exception] shall not apply to the computation of reserves on any contract if such computation employs the reserve practice used for purposes of the most recent annual financial statement filed on or before March 1, 1986, for the type of contract with respect to which reserves are set up." H.R. 3838 (as reported by the Senate Finance Committee), 99th Cong., 2d Sess. § 1022(e) (1986). The deletion of that sentence from the actual 1986 Act is unexplained. Possibly the deletion related to the change in the Conference Bill from a date in March 1986 to year-end 1985 as the trigger date for the "reserve strengthening" exception. Or possibly the

Conference Committee may have recognized that the sentence was difficult to apply to the reserves subject to the 1986 "fresh start" rule which were calculated with respect to policy *claims*, and were not calculated with respect to "contracts." *See supra* p. 26. In any event, for the reasons noted above, the deletion of the limited special rule could not be relevant to any analysis of the plain meaning of the term "reserve strengthening."

B. The Third Circuit erred in concluding that the regulation implements the intent of Congress in a reasonable manner.

Even if the Third Circuit were correct in concluding that the term "reserve strengthening" has no plain meaning and the legislative history is relevant to the analysis, the court was wrong to conclude that the legislative history in this case supports the mechanical test of "reserve strengthening" adopted in the regulation.

In reviewing the legislative history, the Third Circuit focused on a part of one sentence in the Conference Committee report, and a statement of one Senator inserted in the Congressional Record after enactment, as "evidence" for its conclusion that the Conference Committee provided a definition of "reserve strengthening" that was more expansive than that of the Senate Committee and which could be harmonized with the regulation. 111 F.3d at 1063-64. It seems self-evident that a statement of an individual Senator, which was unreviewed by anyone, cannot establish the intent of Congress. With respect to the Conference Report, the Third Circuit quoted the following language to support its labeling of the Conference

Committee's description of "reserve strengthening" as "all inclusive" -- "reserve strengthening" shall be considered to include "'all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year) . . . .' H.R. Conf. Rep. No. 99-841." 111 F.3d at 1065. Yet, a review of the *entire* legislative history can only lead to the conclusion drawn by the Eighth Circuit and the Tax Court in *Western National* -- it "'provides no persuasive rationale for interpreting the statutory term "reserve strengthening" in a manner different from industry usage.'" 65 F.3d at 93 (quoting 102 T.C. at 355).

As discussed above, the change in the statutory language between the Senate version of the provision and the Conference version had no impact on the established meaning of "reserve strengthening." *See infra* Part IV.A.4. The Conference Report states, "The conference agreement modifies the Senate amendment with respect to the *treatment* of "reserve strengthening" under the "fresh start" income forgiveness provision." H.R. Rep. No. 99-841, at II-367 (1986) reprinted in 1986 U.S.C.C.A.N. 4075, 4455 (emphasis added). In the two sentences immediately following the sentence indicating that a "modification" was made, the Conference Report explains that the excluded "reserve strengthening" was any "reserve strengthening" taking place in taxable years beginning after December 31, 1985, rather than "reserve strengthening" reported after March 1, 1986, as the Senate bill had provided. Thus, the "modification" highlighted in the Conference Report is linked directly with the change in the date when the "reserve strengthening" exception to the "fresh start" took effect. Contrary to the Third Circuit's opinion in this case, the

legislative history never says that the conference agreement "expanded" the *definition* of "reserve strengthening."

Further, after describing the change to the date when the "reserve strengthening" exception was to take effect, the Conference Report lists reserve additions that the "reserve strengthening" provision "is considered to include" in juxtaposition with a sentence stating that Congress intended the "reserve strengthening" provision to prevent taxpayers from "artificially" increasing loss reserves and therefore the amount of income forgiven under the "fresh start." H.R. Rep. No. 99-841, at II-367. The Third Circuit's interpretation of the legislative history -- that it proves Congress intended the term "reserve strengthening" to mean any increase during 1986 in pre-1986 accident year loss reserves -- creates an apparent contradiction between those two sentences. The Third Circuit dismissed the resulting contradiction between the two sentences by speculating that the Conference Report used the term "'artificial' in a general sense, to refer to any increases in the reserves other than those resulting from the difference attributed to the discounting of reserves." 111 F.3d at 1065.

The Third Circuit's explanation of the term "artificial" makes no sense. The 1986 Act excluded from the "fresh start" any "reserve strengthening" *during 1986*. Even assuming that the discounting of loss reserves could somehow result in an increase in reserves (a result that intuitively seems unobtainable), Congress' reference to "artificial" reserve increases could not possibly have been intended to differentiate increases due to discounting from all other increases, because insurance companies were not

required to discount their loss reserves for tax purposes during *1986*. The discounting rules took effect in 1987.

The reference to "artificial" increases in the legislative history must have been intended to differentiate unusual loss reserve increases from normal loss reserve increases as the Tax Court believed.[15] 102 T.C. at 356. The mechanical test of the regulation goes far beyond any notion of preventing only artificial loss reserve increases. Indeed, it captures *all* increases to net reserves (and more). *See supra* p. 5. The Third Circuit therefore was wrong to conclude that the regulation is consistent with the Conference Report and that the regulation can be harmonized with Congress' intent.

C. The Third Circuit erred in failing to hold that the regulation is invalid because it reaches beyond even respondent's explanation of congressional intent.

Even if respondent were correct in interpreting "reserve strengthening" to mean any increase in net reserves,

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[15] Although the Conference Report language is ambiguous, the Tax Court's alignment of the two sentences is far more plausible than that of the Third Circuit. The original "reserve strengthening" rule under section 810(d) of the 1954 Code provided an exception to the general rule that annual reserve increases are currently deductible in order to prevent distortions in income caused by unusual or non-periodic reserve increases involving changes in assumptions or methodologies. *See National Life and Accident Ins. Co.*, 524 F.2d at 560. It is entirely logical for Congress to have turned to a "reserve strengthening" exception, with its established insurance tax meaning, to prevent "artificial" increases in reserves from distorting income forgiven under the 1986 Act "fresh start."

the regulation is invalid because it produces absurd and inequitable results that go far beyond the notion of "any increase." Respondent has admitted that the mechanical test in the regulation can result in erroneous computations, but respondent refused to take into account specific examples of inaccuracies furnished by affected insurers. *See* T.D. 8433, 1992-2 C.B. at 148. In the notice of proposed rule making accompanying the regulations, respondent explained:

> Because the test is applied to each unpaid loss reserve, rather than to each separate loss, the test does not take into account the fact that a particular loss payment may exceed, or be less than, the initial estimate of the amount of the loss for which the payment was made. This may result in a failure to include, or an erroneous inclusion of, certain amounts in the computation of reserve strengthening for a particular reserve. For most unpaid loss reserves, however, any potential inaccuracies are likely to offset each other in the aggregate.

FI-139-86, 1991-2 C.B. 946, 947. There simply is no support for the statement that the inaccuracies caused by the mechanical test required by the regulation would tend to offset each other in the aggregate.

1. The absurd results.

As noted by the Tax Court in *Western National*, the mechanical test contained in the regulation produces absurd results. 102 T.C. at 349 n.8, 361. The Tax Court provided an example of such absurd results which demonstrates that the regulation clearly is over broad. *Id.* at 349 n.8.

The example assumes four loss reserves of $500 each included in case reserves by a property and casualty insurer at December 31, 1985. During 1986, two of the case reserves were closed by payments of $750 each. The other two case reserves remained open at December 31, 1986 with no change in the $500 reserve amount. Pursuant to the mechanical test, the Commissioner would find "reserve strengthening" of $500, *i.e.*, 1986 loss reserves, $1,000, less the net of 1985 loss reserves, $2,000, and 1986 payments, $1,500, equals $500. Respondent would disallow as "fresh start" the discount on $500 of the remaining loss reserve under the guise that there was $500 of "reserve strengthening."

Clearly, there were no additions to either loss reserve remaining at December 31, 1986. Since the December 31, 1986 loss reserves included no amounts for the two paid losses, there was no "fresh start" in respect of the two closed claims. Nevertheless, the payments caused the mechanical test to produce "reserve strengthening." Were it not for the respondent's mechanical test contained in the regulation, the closures of the case reserves by payment in 1986 would have had no effect on losses incurred for the taxable year 1987. Because of the mechanical test, however, 1987 losses incurred will be reduced for a discount on a deemed amount of reserve increase which was not included in any reserve for a loss at December 31, 1986 and which, therefore, could not and did not increase the insurer's "fresh start."

Other examples of the absurd results produced by the mechanical test in the regulation are found in the report of Irene Bass, one of petitioner's experts. (Jt. App. at 79, 86.)

Thus, in certain circumstances, the mechanical test of the regulation creates "reserve strengthening" only as the result of claim payments, even if there is *no increase* in reserves affecting the "fresh start." Clearly, respondent has promulgated a regulation that reaches beyond even respondent's broad explanation of congressional intent. Accordingly, the regulation is not a reasonable interpretation of the statute and is invalid.

2. The inequities.

The example in *Western National* can be modified slightly to show the inequities that result from the mechanical test of the regulation. Using the same four claims from the same line of business and accident year but estimated at $1,000 each, rather than $500, at December 31, 1985, assume that two of the claims were paid for $750 each during 1986 and the other two claims remained in loss reserves at $1,000 each at December 31, 1986. The mechanical test would produce reserve weakening of $500, *i.e.*, $2,000 of loss reserves at December 31, 1986 less the net of $4,000 of loss reserves at December 31, 1985 and $1,500 of payments in 1986, equals ($500). This insurer was overreserved at December 31, 1985 in contrast to the insurer discussed above which was underreserved. The overreserved insurer could increase loss reserves for another line of business and accident year, and its "fresh start," by an aggregate of $500 as of December 31, 1986 without fear of "reserve strengthening" under the mechanical test.

Thus, the mechanical test penalizes underreserved insurers which have claimed, as a result of the underreserving, lesser amounts of deductions in 1986 and

prior years than they were entitled to claim. At the same time, insurers which were overreserved at December 31, 1985, within limits allowed under applicable law, not only would be deemed to have weakened loss reserves, but would be able to increase loss reserves and the "fresh start" without fear of any penalty for "reserve strengthening." One of petitioner's experts, James MacGinnitie, provides additional examples of the inequities that arise out of the mechanical test for "reserve strengthening." (Jt. App. at 107-08.)

The above examples demonstrate that the mechanical test in the regulation would not capture some loss reserve increases and captures amounts that are not loss reserve increases simply as a result of the vagaries of an insurer's prior reserving practices. A regulation that confers an extra benefit on one insurer, and an extra burden on another (even though it did not adjust loss reserves, except for adjustments that resulted from claims payments), clearly is not a reasonable interpretation of the statute and is invalid.

CONCLUSION

For the reasons set forth above, the Court should reverse the judgment of the Court of Appeals for the Third Circuit and reinstate the judgment of the Tax Court.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1997

ATLANTIC MUTUAL INSURANCE CO. AND INCLUDIBLE SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

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48 pp

QUESTION PRESENTED

Whether 26 C.F.R. 1.846-3(c) correctly interprets the term "reserve strengthening" as used in Section 1023(e)(3)(B) of the Tax Reform Act of 1986.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A25) is reported at 111 F.3d 1056. The opinion of the Tax Court (Pet. App. A26-A47) is unofficially reported at 71 T.C.M. (CCH) 2154 (1996).

JURISDICTION

The judgment of the court of appeals was entered on April 24, 1997. The petition for a writ of certiorari was filed on July 22, 1997, and was granted on October 20, 1997 (118 S. Ct. 334). The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY PROVISION AND REGULATION INVOLVED

The relevant portions of Section 1023(e) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2404, and Section 1.846-3(c) of the Treasury Regulations on Income Tax, 26 C.F.R. 1.846-3(c), are set forth at Pet. App. A48-A49, A52-A54.

STATEMENT

1. Petitioner is a property and casualty (P & C) insurance company (Pet. App. A6). Such companies maintain an accounting reserve for their "unpaid losses." The reserve for unpaid losses consists of amounts that each insurer estimates it will ultimately be required to pay (i) on losses already reported ("case reserves"), (ii) on losses not yet reported but estimated to have occurred ("incurred but not reported loss reserves") and (iii) in connection with the determination and adjustment of such losses ("loss adjustment expense reserves") (*id.* at A6 n.4).

During the 1986 taxable year, petitioner made net additions to the reserves it maintained for accidents that occurred prior to that year.[1] Those additions were not attributable to changes in the methods of estimation (Pet. App. A45). Instead, they were the result of additional experience on the loss claims and "routine adjustments" of reserves by claims adjusters and management (*ibid.*).

[1] Petitioner's "case reserves" totaled $255,655,141 at the end of 1985 and $277,705,661 at the end of 1986 (J.A. 34 ¶ 29). Petitioner's reserves for losses that were "incurred but not reported" totaled $93,713,687 at the end of 1985 and $111,708,986 at the end of 1986 (J.A. 34-35 ¶ 30). Petitioner's reserves for "loss adjustment expense" totaled $72,317,450 at the end of 1985 and $84,066,519 at the end of 1986 (J.A. 37 ¶ 36).

As applied to reserves of the type involved in this case, Section 1.846-3(c)(3) of the Treasury Regulations defines the term "reserve strengthening" as used in Section 1023(e)(3)(B) of the Tax Reform Act of 1986 to include any additions made to reserves, even if stemming from routine adjustments. The Commissioner of Internal Revenue therefore determined that the increases to petitioner's reserves for losses occurring prior to 1986 constituted "reserve strengthening" under Section 1023(e)(3)(B) of the Tax Reform Act of 1986 (Pet. App. A7). Based on that determination, petitioner was required to recognize additional taxable income of $1,339,039 for 1987, with a resulting deficiency in tax of $519,987 for that year (*ibid.*).

2. Petitioner commenced this action in the Tax Court to contest the deficiency determination of the Commissioner (Pet. App. A7).

a. The issue addressed in this case is whether Section 1.846-3(c) of the Treasury Regulations, 26 C.F.R. 1.846-3(c), correctly defines the term "reserve strengthening," as used in Section 1023(e)(3)(B) of the Tax Reform Act of 1986, to include increases to reserves attributable to routine claims adjustment. That issue was first considered by the Tax Court in *Western National Mutual Insurance Co.* v. *Commissioner*, 102 T.C. 338 (1994), aff'd, 65 F.3d 90 (8th Cir. 1995). In that case, the taxpayer argued that the term "reserve strengthening" is understood in the insurance industry to involve only those increases to reserves that result from changes in the assumptions or methodology used to compute reserves. The taxpayer contended in that case, as petitioner does here, that the term does not encompass the type of increases to unpaid loss reserves that result from routine claims processing. 102 T.C. at

346-347. The taxpayer in *Western National* introduced expert testimony that purported to establish the technical meaning of the term "reserve strengthening" in the insurance industry. The Commissioner did not offer any opposing expert testimony in that case. Instead, the Commissioner relied on the legislative history of Section 1023(e)(3)(B) to support the definition of the term "reserve strengthening" contained in the agency's interpretive regulation. 102 T.C. at 347.

In *Western National*, the Tax Court invalidated the regulation in a reviewed opinion with four judges dissenting. The majority relied on the taxpayer's expert witnesses in concluding that the term "reserve strengthening" has an "industry meaning" that is narrower than the definition contained in the agency's regulation. 102 T.C. at 360. The court concluded that Section 1023(e)(3)(B) of the Tax Reform Act of 1986 incorporates the "industry usage" of the term and is therefore "neither ambiguous nor imprecise" (*id.* at 360 & n.25). Because the regulation conflicts with the "industry meaning" of the term "reserve strengthening," the court concluded that the regulation conflicts with the statute and is therefore invalid. On appeal, the Eighth Circuit affirmed. 65 F.3d 90 (1995).

b. In the present case, both the Commissioner and the taxpayer introduced expert reports at trial that addressed the meaning of "reserve strengthening" in the property and casualty industry. Those expert reports, which are summarized in detail by the courts below, "ma[de] clear that the term 'reserve strengthening' as used in section 1023(e)(3)(B) is subject to more than one interpretation" (Pet. App. A9 & n.5). See also *id.* at A43; pages 18-20, *infra*.

The Tax Court nonetheless again concluded that the taxpayer was not liable for the asserted deficiency (Pet. App. A27). The court stated that its prior decision "was not based solely on expert testimony" (*id.* at A46) but had also been supported by (i) the use of the term "reserve strengthening" in other legislation and (ii) the legislative history of the statute involved in this case (*ibid.*). In discussing the legislative history of Section 1023(e)(3)(B) in this case, however, the court acknowledged that the Conference Committee "substantially revised the 'reserve strengthening' language contained in both the Senate bill and in the accompanying Senate Finance Committee Report," which had limited reserve strengthening to changes in reserve practices (Pet. App. A36). The court further noted that the Conference Committee Report "provided a more expansive definition of the term [reserve strengthening] than that contained in the Finance Committee report" (*id.* at A38). The court therefore agreed that the agency's regulation "provided a definition of 'reserve strengthening' consistent with the conference committee report" (*id.* at A41). But, in *Western National*, the court had emphasized that the Conference Committee Report *also* states that the limitation on "reserve strengthening" is designed "to prevent taxpayers from artificially increasing" reserves (*id.* at A42, quoting H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. at II-367 (1986)). The court reasoned that this reference to artificial adjustments refers "to changes in assumptions or methodology" rather than routine loss adjustments (Pet. App. A42). The court ultimately concluded that, despite the Commissioner's "cogent arguments to the contrary," principles of *stare deci-*

sis required it to adhere to its prior decision in *Western National* (*id.* at A45).

3. The court of appeals reversed (Pet. App. A1-A25). The court concluded that there is no plain meaning, or consistent industry usage, of the term "reserve strengthening" as that term is used in Section 1023(e)(3)(B) of the Tax Reform Act of 1986. To the contrary, the court observed that the "expert testimony here makes clear that the term 'reserve strengthening' as used in [the statute] is subject to more than one interpretation" (Pet. App. A9 & n.5). In view of "the lack of an explicit statutory definition of reserve strengthening" and "the conflicting definitions of reserve strengthening provided by the expert witnesses," the court held that "the Tax Court erred as a matter of law in holding that the meaning of reserve strengthening in section 1023(e)(3)(B) was plain" (Pet. App. A15).[2]

[2] The court of appeals also stated that the Tax Court erred in *Western National* by relying on the meaning of the term "reserve strengthening" as used in the *life* insurance industry. The court explained that the meaning of "reserve strengthening" in the life insurance industry has no direct relevance to the meaning of that term in the property and casualty insurance industry (Pet. App. A12-A13):

> [L]ife insurance companies and P & C insurers are taxed in entirely separate manners. Gross income as well as loss reserves are computed on different bases and assumptions. Actuarial assumptions about interest rates and mortality rates are an integral part of computing future losses which form the basis of the loss reserves in life insurance. On the other hand, P & C loss reserves are determined primarily based on past claims experience and the judgments of the individual claims adjusters.

Finding the words of the statute to be ambiguous, the court concluded that it was required by *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), "to take a deferential approach to ascertaining whether the agency's interpretation is a permissible one" (Pet. App. A15). The court emphasized that "where reasonable minds may differ * * *, courts should defer to the informed experience and judgment of the agency to whom Congress delegated appropriate authority" (*id.* at A24 n.13, quoting *Mourning* v. *Family Publications Service, Inc.*, 411 U.S. 356, 371-372 (1973)). The court held that the broad definition of "reserve strengthening" contained in the regulation satisfies this deferential standard because the agency's interpretation is consistent with the language of the statute, its history and its underlying purpose (Pet. App. A15-A25).

SUMMARY OF ARGUMENT

The definition of "reserve strengthening" set forth in the Treasury Regulation that interprets Section 1023(e)(3)(B) of the Tax Reform Act of 1986 should be sustained because it is consistent with the text and history of the statute and advances the legislative purpose. The term "reserve strengthening" has no statutory definition or common meaning manifested either in industry usage or in prior legislation. Instead, as the court of appeals correctly concluded in this case, "the term 'reserve strengthening' as used in section 1023(e)(3)(B) is subject to more than one interpretation" (Pet. App. A9).

The Treasury's interpretation of this ambiguous statutory term is supported by the structure and history of the statute. The original Senate version of this statute had contained explicit language that

would have narrowly limited the concept of "reserve strengthening" to changes in reserves caused by changes in reserve methodologies. The Senate version of the statute, however, was expressly rejected by the Conference Committee. The definition of "reserve strengthening" contained in the agency's regulation coincides precisely with the definition of that term in the Conference Committee Report, which explains that "reserve strengthening" "include[s] *all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year*" (Pet. App. A17, quoting H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. at II-367 (1986)) (emphasis added). Petitioner ignores this clear legislative history and instead advances the untenable proposition that the Court should adopt the very version of Section 1023(e)(3)(B) that had been proposed by the Senate but rejected by the Conference Committee. As this Court has emphasized, however, courts have a "duty to refrain from reading a phrase into the statute when Congress has left it out." *Keene Corp.* v. *United States*, 508 U.S. 200, 208 (1993).

The Treasury's interpretatation of the statute honors the crucial distinctions that occupied the attention of Congress in enacting this legislation. By faithfully adhering to the text of the statute and the legislative intent, the agency has implemented "the congressional mandate in [a] reasonable manner" and its regulation therefore "must be upheld." *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979), quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973), quoting *United States* v. *Correll*, 389 U.S. 299, 307 (1967).

ARGUMENT

THE TREASURY REGULATION CORRECTLY DEFINES THE TERM "RESERVE STRENGTHENING" IN SECTION 1023(e)(3)(B) OF THE TAX REFORM ACT OF 1986 TO REFER TO ANY ADDITIONS MADE DURING 1986 TO THE RESERVES ESTABLISHED BY PROPERTY AND CASUALTY INSURERS FOR LOSSES INCURRED PRIOR TO THAT YEAR

1. *The Origin of the Statute and Regulation.* Section 832(c)(4) of the Internal Revenue Code authorizes a deduction for "losses incurred" in computing the taxable income of property and casualty insurance companies. 26 U.S.C. 832(c)(4). Prior to 1986, the term "losses incurred" was defined by Section 832(b)(5) of the Code to mean the amount of "losses paid" during the year plus the increase (or minus the decrease) in "unpaid losses." 26 U.S.C. 832(b)(5) (1982).[3] That pre-1986 provision gave an unwarranted benefit to property and casualty companies, for it failed to take the time value of money into account in determining the permissible deduction. See S. Rep. No. 313, 99th Cong., 2d Sess. 499-500 (1986); note 3, *supra*.

Congress attempted to solve this problem by adding Section 846 to the Code as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023(c), 100 Stat. 2399.

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[3] A property and casualty company was permitted to deduct the full amount of the estimated loss in the year the loss occurred, even though the claim might not be paid for several years. When the claim was paid, the company would not receive any additional deduction (assuming that the payment equalled the original estimate) because the payment would be offset by a corresponding reduction in its loss reserves.

That Section requires unpaid losses to be discounted to present value when claimed as a deduction. 26 U.S.C. 846. As part of the same legislation, Congress amended Section 832(b)(5) to reflect the new discounting requirements. Under that new Section, the deduction for "losses incurred" is computed by adding to losses paid "all discounted unpaid losses (as defined in section 846) outstanding at the end of the taxable year" and deducting therefrom "all discounted unpaid losses outstanding at the end of the preceding taxable year." 26 U.S.C. 832(b)(5)(A).

Congress enacted a series of transitional rules to implement these new accounting procedures. Section 1023(e)(1) of the Tax Reform Act of 1986 specifies that the new discounting rules "shall apply to taxable years beginning after December 31, 1986." 100 Stat. 2404. As the Tax Court noted (Pet. App. A34), if no exception had been made to this new requirement, property and casualty companies would have been required to compare "old law" (undiscounted) year-end 1986 reserves with "new law" (discounted) year-end 1987 reserves, thus causing a one-time reduction of the losses incurred deduction in 1987. To avoid that sharp consequence, Congress established a transitional rule—Section 1023(e)(2) of the Tax Reform Act of 1986—which specifies that, in computing the 1987 deduction for losses incurred, the year-end 1986 reserves are also to be discounted to present value.

Without any further transitional provision, this special rule would have required property and casualty companies to take into income in 1987 the excess of the undiscounted year-end 1986 reserves over the discounted year-end 1986 reserves. This is because (i) the new requirement of discounting constitutes a change of accounting method, (ii) that new accounting

method yields a double deduction for property and casualty companies[4] and (iii) Section 481(a) of the Code requires an appropriate adjustment to prevent the taxpayer from obtaining a double deduction created by a change in accounting method.[5] Congress decided to permit taxpayers to obtain a limited double

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[4] The double deduction may be illustrated as follows:

No discounting. Assume that an automobile accident occurs in Year 1, and the insurance company estimates it will eventually pay a total of $10 in claims stemming from that accident. Assume further that the $10 is in fact paid out in Year 5.

The tax treatment is as follows: In Year 1, the company adds $10 to its "unpaid losses," and obtains a deduction of $10. In Year 5, when the company makes the payment, it increases its "losses paid" by $10, but reduces its "unpaid losses" by $10. This is a wash.

With discounting. Assume the same facts as above. Assume, in addition, that discounting goes into effect in Year 4, and the company's "unpaid losses" account is reduced in that year, tax-free, to $9.

The tax treatment is as follows: The company again gets a Year 1 deduction of $10. In Year 5, however, when the company makes the payment, it increases its "losses paid" by $10, but reduces its "unpaid losses" by only $9, and thus gets a net additional deduction of $1. The company thus gets a total deduction (in Year 1 and Year 5) of $11 for a $10 payment.

[5] Under Section 481(a) of the Code, if the taxpayer's taxable income is computed "under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed," then "there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted * * *." 26 U.S.C. 481(a).

deduction in this particular situation, however, by enacting a "fresh start" provision in Section 1023(e)(3)(A) of the Tax Reform Act of 1986. Section 1023(e)(3)(A) provides (100 Stat. 2404):

(3) FRESH START.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, any difference between—

(i) the amount determined to be the unpaid losses and expenses unpaid for the year preceding the 1st taxable year of an insurance company beginning after December 31, 1986, determined without regard to paragraph (2) [*i.e.*, without discounting], and

(ii) such amount determined with regard to paragraph (2) [*i.e.*, with discounting],

shall not be taken into account for purposes of the Internal Revenue Code of 1986.

The double deduction provided by the "fresh start" provision gave property and casualty companies an incentive to increase their unpaid-loss reserves during the 1986 taxable year. See Logue, *Toward a Tax-Based Explanation of the Liability Insurance Crisis*, 82 Va. L. Rev. 895, 925-930 (1996). Congress addressed that problem by enacting Section 1023(e)(3)(B) of the Tax Reform Act of 1986, which precludes application of the "fresh start" provision—and thus permits the normal application of Section 481(a)—with respect to any "reserve strengthening" that occurred in 1986. Section 1023(e)(3)(B) provides (100 Stat. 2404):[6]

(B) RESERVE STRENGTHENING IN YEARS AFTER 1985.—Subparagraph (A) [the fresh start provision] shall not apply to any reserve strengthening in a taxable year beginning in 1986, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986.

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[6] The enacted version of this "reserve strengthening" provision differs from the version contained in the bill approved by the Senate Finance Committee. That bill had explicitly linked reserve strengthening to a change in the insurer's reserve practice. It provided (H.R. 3838, 99th Cong., 2d Sess., § 1022(e)(3)(B) (1986), as reported by the Senate Finance Committee, May 29, 1986) (emphasis added):

(B) *Reserve Strengthening After March 1, 1986.* * * * [The fresh start adjustment] shall not apply to any reserve strengthening reported for Federal income tax purposes after March 1, 1986, for a taxable year beginning before January 1, 1987, and such strengthening shall be treated as occurring in the taxpayer's 1st taxable year beginning after December 31, 1986. *The preceding sentence shall not apply to the computation of reserves on any contract if such computation employs the reserve practice used for purposes of the most recent annual statement filed on or before March 1, 1986, for the type of contract with respect to which such reserves are set up.*

See 132 Cong. Rec. 16,130-16,131 (1986). The Senate Report stated that "[t]he committee intends that any adjustments to reserves that are attributable to changes in reserves on account of changes in the basis for computing reserves (i.e., reserve strengthening or reserve weakening) in a taxable year beginning before January 1, 1987, are not taken into account in determining taxable income after the effective date." S. Rep. No. 313, *supra*, at 510.

The Conference Committee Report explains the application of this provision (H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. at II-367 (1986)) (emphasis added):

Fresh start adjustment

The conference agreement follows the Senate amendment with respect to providing a fresh start adjustment—i.e., a forgiveness of income—for the reduction in reserves resulting from discounting the opening reserves in the first post-effective date taxable year of the provision. The conference agreement modifies the Senate amendment with respect to the treatment of reserve strengthening under the fresh start income forgiveness provision. Under the conference agreement, reserve strengthening in taxable years beginning after December 31, 1985, is not treated as a reserve amount for purposes of determining the amount of the fresh start. Instead, such reserve strengthening additions to loss reserves in taxable years beginning in 1986 are treated as changes to reserves in taxable years beginning in 1987, and are subject to discounting. *Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year)*, and all additions to reserves resulting from a change in the assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves. This provision is intended to prevent taxpayers from artificially increasing the

amount of income that is forgiven under the fresh start provision.

In 1992, the Treasury promulgated a regulation to interpret and implement the reserve strengthening transitional rule. Section 1.846-3 of the Treasury Regulations, 26 C.F.R. 1.846-3, provides:

(c) *Rules for determining the amount of reserve strengthening (weakening)*—(1) *In general.* The amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in 1986. For purposes of section 1023(e)(3)(B) of the 1986 Act, the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. * * *

* * * * *

(3) *Accident years before 1986*—(i) *In general.* For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of that taxable year [*i.e.*, 1986] exceeds (is less than)—

(A) The reserve at the end of the immediately preceding taxable year [*i.e.*, 1985]; reduced by

> (B) Claims paid and loss adjustment expenses paid ("loss payments") in the taxable year beginning in 1986 with respect to losses that are attributable to the reserve. * * * [7]

In an accompanying explanation, the Treasury observed that the broad definition of reserve strengthening provided by the regulation conformed to the Conference Committee Report (1992-2 C.B. 146, 148):

> The legislative history indicates that for purposes of the fresh start adjustment the term "reserve strengthening" includes "all additions to reserves attributable to an increase in an estimate of reserves established for a prior accident year (taking into account claims paid with respect to that accident year), * * * as well as all unspecified or unallocated additions to loss reserves". * * * Thus, Congress adopted an expansive and mechanical definition of reserve strengthening that is reflected in the final regulations.

2. *The regulation correctly interprets the term "reserve strengthening" in Section 1023(e)(3)(B) of the Tax Reform Act of 1986.* The Court has consistently held that "Treasury Regulations 'must be

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[7] The final regulations provide two exceptions from this rule: (1) an amount added to a reserve in 1986 as a result of a loss reported to the taxpayer from a mandatory state or federal assigned risk pool if the amount of the loss reported is not discretionary with the taxpayer; and (2) payments made with respect to reinsurance assumed during 1986 or amounts added to the reserve to take into account reinsurance assumed for a line of business during 1986, but only to the extent the amount does not exceed the amount of a hypothetical reserve for the reinsurance assumed. 26 C.F.R. 1.846-3(c)(3)(ii). Neither exception applies in this case.

sustained unless unreasonable and plainly inconsistent with the revenue statutes.'" *Commissioner* v. *Portland Cement Co.*, 450 U.S. 156, 169 (1981), quoting *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). "The choice among reasonable interpretations is for the Commissioner, not the courts." *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 488 (1979). See also *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-843 (1984). Deference is given to the Commissioner's interpretations of tax statutes because (*National Muffler Dealers Ass'n* v. *United States*, 440 U.S. at 477):

> "Congress has delegated to the * * * Commissioner * * * , not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. § 7805(a)." *United States* v. *Correll*, 389 U.S., at 307. That delegation helps ensure that in "this area of limitless factual variations," *ibid.*, like cases will be treated alike. It also helps guarantee that the rules will be written by "masters of the subject," *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect.

Applying this established rule of deference in this case, the court of appeals correctly concluded that the definition of "reserve strengthening" contained in the regulation is a reasonable interpretation that is not "plainly inconsistent with the revenue statute[]" and must therefore be upheld (*Commissioner* v. *South Texas Lumber Co.*, 333 U.S. at 501).

a. *The regulation is not "plainly inconsistent" with the statute.* "In ascertaining the plain meaning

of the statute, the court must look to the particular statutory language at issue, as well as the language and design of the statute as a whole." *Sullivan* v. *Stroop*, 496 U.S. 478, 482 (1990), quoting *K Mart Corp.* v. *Cartier, Inc.*, 486 U.S. 281, 291-292 (1988). As both of the courts of appeals that have addressed "the language and design" of this statute have concluded, "[t]he meaning of reserve strengthening is not immediately apparent from the face of this provision." *Western National Mutual Ins. Co.* v. *Commissioner*, 65 F.3d at 92. "The statute does not provide a definition" of the term (*ibid.*), nor does the dictionary, nor does any common usage. And, while petitioner continues to assert that industry practice provides a definitive meaning to the concept of "reserve strengthening" (Pet. Br. 27-28), even its own expert witnesses conceded, in the course of their efforts to "construct[] a working definition of the term" (J.A. 68), that "the term *reserve strengthening* is not a well-defined [property and casualty] insurance or actuarial term of art" (J.A. 60). Petitioner's witnesses acknowledged that the term has different meanings and different usages for "claims managers," "financial executives," "insurance analysts," and others (J.A. 64-66). Industry witnesses consistently noted that "the term 'reserve strengthening' has various meanings, rather than a single universal meaning," and that its meaning varies depending upon the context in which the term is used (J.A. 124). See also J.A. 125, 191, 200. As one expert summarized, even among insurance actuaries, the term is used "in ways that are conflicting and confusing." J.A. 187.[8]

[8] Petitioner errs in suggesting (Pet. 28) that government witnesses supported the narrow definition of "reserve strengthening" that was proposed by petitioner's expert. In fact, the government witnesses stated that the definition proposed by petitioner's expert "is a restricted definition and is not the most commonly understood definition" of reserve strengthening (J.A. 191). See also note 9, *infra*.

The court of appeals thus correctly concluded that "the term 'reserve strengthening' as used in section 1023(e)(3)(B) is subject to more than one interpretation" (Pet. App. A9).[9]

That the text of the statute lacks a "plain" meaning is demonstrated by the very fact that petitioner found it necessary to have recourse to "expert" testimony to "construct[] a working definition" (J.A. 68) of "reserve strengthening" from among the several different usages of that term within the insurance industry.[10] Once a court undertakes to investigate sources

[9] Like the court of appeals, the Tax Court noted that the Commissioner "presented expert testimony which indicates that the term is subject to more than one interpretation" and that "[o]ne expert opined that the regulation's definition provided a valid measurement of 'reserve strengthening'" (Pet. App. A43). Any contention that a single, industry definition exists for the term "reserve strengthening" is thus not consistent with the record and was not accepted by either of the courts below. Indeed, petitioner implicitly acknowledges that fact, for it now asserts that "there is ultimately no need for experts to validate the meaning of the statutory term" (Pet. Br. 32). We agree that the meaning of the ambiguous statutory term should be determined by review of the legislative history, rather than from the testimony of the expert witnesses engaged to describe the multiple, inconsistent industry usages of the term.

[10] In *Massachusetts* v. *Blackstone Valley Electric Co.*, 67 F.3d 981, 986-987 (1st Cir. 1995), the court held that a statutory term is ambiguous when conflicting expert explanations reveal an inconsistent usage of the term. As the court stated in *Brechteen Co.* v. *United States*, 854 F.2d 1301, 1303 (Fed. Cir.

beyond the mere text of the statute to determine its meaning, it is obviously the legislative history of the statute—rather than the carefully worded reports of hired witnesses—that is the best source for determining the intent of Congress. It is, after all, the intent of Congress, not the persuasive powers of expert witnesses, that should govern construction of a statute. As this Court has emphasized, when a statutory term such as "reserve strengthening" lacks an obvious or plain meaning, the interpretive regulation of the agency charged with its enforcement should be upheld "unless the legislative history or the purpose and structure of the statute clearly reveal a contrary intent on the part of Congress." *Chemical Manufacturers Ass'n* v. *Natural Resources Defense Council, Inc.*, 470 U.S. 116, 126 (1985).[11]

1988), "if words are really and truly plain, it ought not to be necessary to establish their meaning by recourse to technical or scientific dictionaries where definitions contrary to common speech may often be found." See also *National Railroad Passenger Corp.* v. *Boston & Maine Corp.*, 503 U.S. 407, 418 (1992) ("The existence of alternative dictionary definitions of the word 'required,' each making some sense under the statute, itself indicates that the statute is open to interpretation.").

[11] Petitioner misapprehends the "plain meaning" rule of statutory construction. The principle that courts ordinarily will not consult legislative history in construing unambiguous statutes applies only when the statute is "plain and unambiguous on its face." *TVA* v. *Hill*, 437 U.S. 153, 184 n.29 (1978). That principle does not apply to terms such as "reserve strengthening" which lack a "plain and unambiguous" meaning. When the statute is not "plain and unambiguous on its face," the Court "seek[s] guidance in the statutory structure, relevant legislative history, congressional purposes expressed in the [statute], and general principles respecting the proper

b. *The regulation is directly supported by the legislative history and the structure of the statute.* The court of appeals correctly concluded that the agency's interpretive regulation draws direct and substantial support from the legislative history of the statute. The Conference Report, which is entitled to great weight in interpreting the statute (*National Ass'n of Greeting Card Publishers* v. *United States Postal Service*, 462 U.S. 810, 832 n.28 (1983)), expressly states, as the regulation provides, that the term "[r]eserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior [*i.e.*, a pre-1986] accident year" (Pet. App. A17, quoting H.R. Conf. Rep. No. 841, *supra*, at II-367).[12]

allocation of judicial authority to review agency orders." *Florida Power & Light Co.* v. *Lorion*, 470 U.S. 729, 737 (1985).

The fallacy in petitioner's argument is further evidenced by its reliance on other statutes involving the *life* insurance industry in an effort to ascertain a "plain meaning" for the term "reserve strengthening" in Section 1032(e)(3)(B) of the 1986 Act. See pages 26-35, *infra*. If the meaning of Section 1023(e)(3)(B) were "plain," those other statutes would be irrelevant. See *Greenport Basin & Construction Co.* v. *United States*, 260 U.S. 512, 516 (1923) ("As the language of the act is clear, there is no room for the argument of plaintiff drawn from other revenue measures"); 2B N. Singer, *Sutherland Statutory Construction* § 51.01, at 117 (5th ed. 1992) ("[I]n line with the basic rule on the use of extrinsic aids, other statutes may not be resorted to if the statute is clear and unambiguous.").

[12] The Conference Report further explains that "reserve strengthening" for the *1986* accident year encompasses only those "additions to reserves *resulting from a change in the assumptions* (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) *used in estimating losses for the 1986 accident year*." H.R. Conf. Rep.

As both courts below correctly recognized (Pet. App. A25, A41), the broad definition of "reserve strengthening" provided by the regulation is thus perfectly consistent with the explanation and definition of that term contained in the Conference Report.

The court of appeals also correctly observed that the Conference Committee revision of the Senate version of Section 1023(e)(3)(B) further demonstrates that Congress did *not* intend to restrict "reserve strengthening" to changes in reserves that result only from changes in reserve practices. The Senate version of the bill had contained additional language that explicitly linked the scope of "reserve strengthening" to changes in reserve methodologies from those used in the prior year. See note 6, *supra*. That Senate provision, however, was rejected and deleted

No. 841, *supra*, at II-367 (emphasis added). The Report thus (i) provides different explanations of the term "reserve strengthening" for additions to reserves for pre-1986 accident years than for additions to reserves for the 1986 accident year, (ii) limits that term to additions to reserves attributable to changes in underlying assumptions *only* with respect to the 1986 accident year and (iii) provides a broader definition of that same term to encompass "all" additions to reserves for pre-1986 accident years. The different applications of the term "reserve strengthening" for pre-1986 accident years and for the 1986 accident year result from the fact that there are no reserves (and thus no reserves to "strengthen") for 1986 accidents prior to the beginning of that year. Section 1.846-3(c)(2) of the Treasury Regulations defines "reserve strengthening" for the 1986 accident year in exact conformity with the definition contained in the Conference Committee Report and that aspect of the regulation is not challenged in this case. See Pet. App. A52-A53.

by the Conference Committee.[13] In doing so, the Conference Committee emphasized that "[t]he conference agreement modifies the Senate amendment with respect to the treatment of reserve strengthening" and provides a more expansive definition of that term than the Senate Finance Committee had provided. H.R. Conf. Rep. No. 841, *supra*, at II-367.

As the court of appeals emphasized (Pet. App. A18-A19), Congress consciously and intentionally rejected the limiting language contained in the "reserve strengthening" provision of the Senate version of the bill. Senator Wallop, who was an opponent of that change, extensively commented on that very fact. He explained that "the reserve strengthening feature [of the Senate bill] was significantly modified in conference" and that the broader Conference Committee definition was based on "the notion that reserve strengthening actions taken by insurance companies during 1986 for prior accident years is heavily motivated by the desire to avoid Federal income taxes." 132 Cong. Rec. 32,625 (1986).[14] Although such

[13] Petitioner is wrong in stating that "the deletion of that sentence [in the Senate bill] from the actual 1986 Act is unexplained" and in speculating that it was removed by the Conference Committee either due to an adjustment of the starting date for the reserve strengthening provision or because of its reference to a "contract" (Pet. Br. 41-42). The rejection of the Senate version of the bill was explained both by Senator Wallop and by the Conference Report. It was rejected in Conference precisely to ensure that the term "reserve strengthening" would apply broadly to "all" additions to reserves and would not be limited only to changes in reserves resulting from changes in reserve methodologies. H.R. Conf. Rep. No. 841, *supra*, at II-367.

[14] Although Senator Wallop stated that he disagreed with the Conference Committee's approach, he acknowledged "that

"statements by individual legislators should not be given controlling effect, * * * when they are consistent with the statutory language and other legislative history, they provide evidence of Congress' intent." *Brock* v. *Pierce County*, 476 U.S. 253, 263 (1986).

Petitioner's position in this case is thus ultimately based on the untenable proposition that this Court should adopt the very version of Section 1023(e)(3)(B) that had been proposed by the Senate but rejected by the Conference Committee. As this Court has emphasized, however, courts have a "duty to refrain from reading a phrase into the statute when Congress has left it out." *Keene Corp.* v. *United States*, 508 U.S. 200, 208 (1993).

c. *The interpretation of the term "reserve strengthening" contained in the regulation advances the purpose of the statute.* The court of appeals also correctly concluded (Pet. App. A22-A23) that the definition of "reserve strengthening" contained in the regulation advances the purpose of the statute by preventing abuses of the fresh start provision. The Conference Report explains that the requirement that "all additions to reserves" be treated as "reserve strengthening" is intended to "prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provi-

increases in reserves decrease an insurance company's Federal tax burden." 132 Cong. Rec. 32,625 (1986). His personal view was that "[t]he Senate bill's reserve strengthening provision was fair" and that "[t]he conference modification substitutes a simplistic, cook-book approach that is entirely inappropriate" (*ibid.*).

sion." H.R. Conf. Rep. No. 841, *supra*, at II-367.[15] As the court of appeals correctly observed, to interpret the term "artificial" in the Conference Report as narrowing the definition of "reserve strengthening" to additions to reserves attributable to changes in reserve practice "would mean that the Conference Committee intentionally contradicted itself" (Pet. App. A23). Instead, as Senator Wallop recognized in his comments criticizing the Conference Committee revisions of the Senate bill (*id.* at A18, quoting 132 Cong. Rec. 32,625 (1986)), the Conference Committee adopted its broad definition of "reserve strengthening" because it concluded that a broad, prophylactic, "cook-book" rule was needed to preclude property and casualty companies from taking artificial advantage of the fresh start provision by increasing their reserves for pre-1986 accident years. See notes 13 & 14, *supra*.

The broad definition of "reserve strengthening" adopted by the Conference Committee is a response to the fact that property and casualty companies exercise a wide discretion in setting reserves and could therefore seek to take advantage of the statutory fresh start under the guise of making "routine" reserve adjustments. The "manipulation of [property and casualty loss] reserves to produce the desired operating results is a constant danger." T. Peterson, *Loss-Reserving—Property/Casualty Insurance* 11 (1981). Indeed, recently published surveys of "aggre-

[15] As Judge Halpern noted in dissent in the Tax Court's decision in *Western National*, 102 T.C. at 373, the term "artificial" refers to "artful" or "cunning" increases in reserves. See *Webster's Third New International Dictionary* 124 (1986).

gate industry data" conducted for 1985-1987 are "broadly consistent" with the conclusion that "tax-motivated reserving" occurred in the property and casualty industry during that period. Bradford & Logue, *The Influence of Income Tax Rules on Insurance Reserves* 34-35 (National Bureau of Economic Research, Working Paper 5902 (1997)).

This is not, of course, to suggest that *every* insurer sought to indulge in "tax-motivated reserving" during this time period. It does, however, reflect that it was reasonable for Congress to conclude that a prophylactic rule was an appropriate response to potential abuse of the fresh start provision. As Judge Friendly stated in *Commissioner* v. *Pepsi-Cola Niagara Bottling Corp.*, 399 F.2d 390, 392 (2d Cir. 1968), "a legislature seeking to catch a particular abuse may find it necessary to cast a wider net."

3. *The prior legislation on which petitioner relies does not support a contrary conclusion.* Notwithstanding the facial ambiguity of the phrase "reserve strengthening," petitioner contends that a "plain" meaning for the term can be found from its "longstanding use in insurance tax law" and from its "prior use in a virtually identical provision" enacted in 1984 (Pet. Br. 28). These contentions are not correct.

a. Petitioner asserts that the term "reserve strengthening" has a "longstanding use" in insurance tax law to describe only additions to insurance reserves that result from changes in reserve assumptions or methodologies. The statutes and regulations that petitioner cites (Pet. Br. 15-17), however, do not purport to define the term "reserve strengthening." Instead, they implement the statutory scheme of the Life Insurance Company Income Tax Act of 1959,

Pub. L. No. 86-69, 73 Stat. 112. That Act does not refer to, or even contain, the term "reserve strengthening." Instead, it provided detailed tax consequences for changes in "the basis" employed by insurers in determining their life insurance reserves. See 26 U.S.C. 810(d)(1) (1976). The Act generally required life insurance companies to spread over a ten-year period the loss deduction associated with any increase of reserves resulting from a change in "the basis" of the reserve accounting method that they employed. *Ibid.*

The regulation that implemented that statutory requirement also did not purport to define the term "reserve strengthening," for that term was not contained in the statute. In describing the sort of changes in "the basis" of reserve accounting that the statute addresses, the regulation used the term "reserve strengthening" only in a caption. 26 C.F.R. 1.810-3(a). That term was not thereafter defined or even mentioned in the text of that regulation. See *ibid.*[16]

A change in reserves that results from a change in "the basis" of setting reserves is, of course, only one type of "reserve strengthening." It is not the *only* type of reserve strengthening known in the insurance industry and does not represent an exclusive or comprehensive definition of that term. See pages 18-

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[16] The regulation issued under Section 810(d)(1) provides an example of how that statute applied in the context of "reserve strengthening *attributable to the change in basis*" (26 C.F.R. 1.810-3(b), Ex. 2) (emphasis added). Nothing in that regulation, or in that statute, purports to provide any comprehensive definition (or, indeed, any definition at all) for the term "reserve strengthening" as used throughout the entire insurance industry.

20 & note 16, *supra*. Instead, as the Conference Committee Report on the statute involved in this case states, "reserve strengthening" also refers more generally to "all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year" (Pet. App. A17, quoting H.R. Conf. Rep. No. 841, *supra*, at II-367).

Unlike the statute involved in the present case, the narrow focus of Section 810(d)(1) in the Life Insurance Company Income Tax Act of 1959 was only on changes in "the basis" of accounting for reserves. That statute, by its very terms, did not purport to apply broadly to all "reserve strengthening" actions and the concept of "reserve strengthening" does not even appear in the statutory text. The court of appeals therefore correctly rejected petitioner's suggestion that the rulings and decisions that employ the term "reserve strengthening" in describing the application of the limitations formerly contained in Section 810(d)(1) on changes in "the basis" of reserving life insurance claims establish a comprehensive definition of the term "reserve strengthening" for all purposes (Pet. App. A12-A13).[17] In particular, as the court emphasized, neither that statute nor its regulation purports to define the term "reserve strengthening" in the property and casualty industry to mean

[17] The decisions cited by petitioner do not purport to establish a definition of "reserve strengthening" for property and casualty industry purposes. See Pet. Br. 18, citing *Jefferson Standard Life Ins. Co.* v. *United States*, 408 F.2d 842, 850 (4th Cir.), cert. denied, 396 U.S. 828 (1969), and *National Life & Accident Ins. Co.* v. *United States*, 381 F. Supp. 1034, 1037 (M.D. Tenn. 1974), aff'd, 524 F.2d 559 (6th Cir. 1975).

only changes in "the basis" or method employed for reserve accounting (*id.* at A13-A14).[18]

Moreover, "life insurance companies and [property and casualty] insurers are taxed in entirely separate manners. Gross income as well as loss reserves are computed on different bases and assumptions." Pet. App. A12.[19] These differences in the taxation of life

[18] Petitioner errs in stating (Pet. Br. 18) that there is precedent involving property and casualty companies that "shows that the term 'reserve strengthening' consistently has been used for insurance tax purposes to mean increases in reserves involving changes in assumptions or methodologies." The precedent cited by petitioner involves the calculation of life insurance reserves under the former provisions of the Life Insurance Company Income Tax Act of 1959. The single authority cited by petitioner (Pet. Br. 17-18) involving a property and casualty company—Rev. Rul. 65-240, 1965-2 C.B. 236—addressed the *life* insurance reserves of a company that had issued both life and property and casualty insurance. As the court of appeals correctly noted in rejecting petitioner's reliance on these authorities, the rulings issued under the Life Insurance Company Income Tax Act of 1959 "do not define reserve strengthening with respect to P & C loss reserves" (Pet. App. A13-A14).

[19] There are fundamental differences between the reserve-setting processes for life insurance and other types of insurance that preclude the facile importation of life insurance reserve concepts into statutes dealing with other types of insurers. Life insurance reserves are computed on the basis of recognized mortality tables and assumed rates of interest. 26 U.S.C. 816(b)(1). See *National Life & Accident Ins. Co.* v. *United States*, 381 F. Supp. at 1037. "Unlike life insurance reserves, which are based on rather reliable studies of prior mortality experience for large age groups, property and liability loss reserves must take into account expected loss experience, using everchanging risk circumstances." C. Galloway & J. Galloway, *Handbook of Accounting for Insurance Companies* 227-228 (1986). See also J.A. 30 ("P/C insurers generally establish case

insurance companies and other insurers are the sort of "variables [that] render every problem of statutory construction unique" (*United States* v. *Universal C.I.T. Credit Corp.*, 344 U.S. 218, 221 (1952)). See *Alinco Life Ins. Co.* v. *United States*, 373 F.2d 336, 352 (Ct. Cl. 1967) (tax provisions relating "primarily to casualty-type insurance * * * are rather meaningless in pure life insurance"). Indeed, petitioner's experts did not even advert to life insurance practices in their testimony concerning the concept of "reserve strengthening" in the property and casualty industry (J.A. 49-120). They acknowledged instead that "the term 'reserve strengthening' is not a well-defined PC insurance or actuarial term of art to be found in PC actuarial, accounting, or insurance regulatory literature" (J.A. 60).

The "longstanding" provisions of the Life Insurance Company Income Tax Act of 1959 that govern the tax consequences of changes in "the basis" of life insurance reserves thus do not define the concept of "reserve strengthening" in the property and casualty industry. Nothing in the text or history of Section 1023(e)(3)(B) of the 1986 Act suggests that Congress sought to incorporate the distinctly different text of the 1959 Act. Indeed, if Congress *had* desired in 1986 to limit the concept of "reserve strengthening" in Section 1023(e)(3)(B) to changes in "the basis" of calculating reserves (26 U.S.C. 810(d)(1) (1976)), there would obviously have been no reason to reject the Senate version of the 1986 bill. The Senate version,

reserves by using estimates of individual claims made by individual claims adjusters, whose estimates are usually revised over time according to the available information and individual judgment and experience of the adjuster").

however, *was* rejected precisely because Congress desired to ensure that "all" reserve increases would be encompassed within the "reserve strengthening" limitation of the fresh start provision. See pages 22-25, *supra*.

b. Petitioner similarly errs in contending (Pet. Br. 20-25) that the term "reserve strengthening" in Section 1023(e)(3)(B) of the 1986 Act draws a "plain" meaning from the statutory reference to "reserve strengthening" in Section 216(b) of the Tax Reform Act of 1984, Pub. L. No. 98-369, Div. A, 98 Stat. 759.[20] In the latter provision, Congress provided a fresh start adjustment for life insurance reserves and, in making that adjustment inapplicable to "any reserve strengthening" in 1983, added a sentence to that statute that expressly specified that the "reserve strengthening" limitation "shall not apply * * * if [the reserve] computation employs the reserve practice used * * * before * * * for the type of

[20] The 1984 legislation provided (emphasis added):

(3) *Reinsurance transactions, and reserve strengthening, after September 27, 1983.*—

(A) *In general.*—Paragraph (1) [*i.e.*, the fresh start adjustment] shall not apply * * *

* * * * *

(ii) to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984.

Clause (ii) shall not apply to the computation of reserves on any contract issued if such computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which such reserves are set up.

[insurance] with respect to which such reserves are set up." *Ibid.*

As the court of appeals correctly concluded (Pet. App. A14-A15), the "reserve strengthening" provision applicable to life insurance reserve computations under the 1984 provision *supports* the Treasury's interpretation of the term "reserve strengthening" as used in Section 1023(e)(3)(B) of the 1986 Act. In enacting the life insurance provisions in 1984, Congress added language to the statute that explicitly *excluded* ordinary increases in reserves—increases that did not result from a change in reserve practices —from the operation of the "reserve strengthening" clause. A similar exclusion was proposed in the Senate version of Section 1023(e)(3)(B) of the 1986 legislation, but that exclusion was purposefully deleted by the Conference Committee. As the court of appeals correctly observed (Pet. App. A14), the deletion of this exclusion of ordinary reserve increases from the operation of the "reserve strengthening" clause plainly indicates that Congress did *not* intend to restrict the "reserve strengthening" provision in Section 1023(e)(3)(B) to changes in reserve practices.[21] "Where Congress includes limiting language in an earlier version of a bill but deletes it prior to enactment, it may be presumed that the limitation

[21] The Conference Committee Report emphasizes that "[t]he conference agreement modifies the Senate amendment with respect to the treatment of reserve strengthening" and provides a more expansive definition of the term (for pre-1986 accident years) than the Senate Finance Committee had provided. H.R. Conf. Rep. No. 841, *supra*, at II-367.

was not intended." *Russello* v. *United States*, 464 U.S. 16, 23-24 (1983). See also pages 22-25, *supra*.[22]

c. Petitioner relies (Pet. 14-15) on several cases that invoke the familiar principle of statutory construction that, when Congress uses the same terms in the same (or closely related) statutes, those terms are presumed to have the same meaning. For the reasons that we have explained, however, that principle does not help petitioner in this case. Congress used different language in different contexts to address different subjects in these statutes.[23]

[22] Petitioner strains (Pet. Br. 38-42) to avoid the obvious implication of the additional language in the 1984 Act. Congress specified in 1984 that the "reserve strengthening" limitation on the fresh start provision for life insurance companies was not to apply if the insurer "employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983" (Pet. Br. 39). Petitioner contends that this restriction on "reserve strengthening" in the 1984 provision was intended to apply only "for contracts that were newly 'issued' in 1983" (*id.* at 40). That assertion, however, is hardly helpful to petitioner. Under petitioner's theory, the term "reserve strengthening" would have incorporated that limitation *without* the additional text in the statute. Petitioner fails to acknowledge that, if the term "reserve strengthening" has the meaning that petitioner asserts, the *express* language making the 1984 provision inapplicable "if such computation employs the reserve practice [previously] used" would have been unnecessary.

[23] Moreover, the principle that similar terms in the same or related statutes are presumed to have the same meaning is not an inexorable rule of law. It is instead an "axiom of experience" employed in the absence of differing circumstances or contrary evidence of legislative intent. See *NationsBank of North Carolina, N.A.* v. *Variable Annuity Life Ins. Co.*, 513 U.S. 251, 262 (1995). The principle cannot trump the intention of Congress as expressed in the Conference Committee Report.

The Life Insurance Company Income Tax Act of 1959, on which petitioner relies, concerned the tax treatment of life insurance reserves and used significantly different language than Congress employed in Section 1023(e)(3)(B) of the 1986 Act. See pages 26-27, *supra*. And, although petitioner emphasizes that the 1984 "reserve strengthening" provision for the life insurance industry was "virtually" identical to the 1986 provision involved in this case (Pet. Br. 28, 32), petitioner fails to acknowledge the obvious fact that the two provisions are not "precisely" identical. They differ in this one important respect: the 1984 provision excluded from the "reserve strengthening" provision any changes in reserves that did not result from changes in reserve practices; the 1986 provision contained no such exclusion. Instead, as the Conference Committee emphasized in describing the operation of the statute, the "reserve strengthening"

That report is entitled to "great weight" in ascertaining the meaning of the legislation (*National Ass'n of Greeting Card Publishers* v. *United States Postal Service*, 462 U.S. at 832 n.28) for, "next to the statute itself," it "is the most persuasive evidence of congressional intent" (*Demby* v. *Schweiker*, 671 F.2d 507, 510 (D.C. Cir. 1981)). See also *Farmers Reservoir & Irrigation Co.* v. *McComb*, 337 U.S. 755, 764 (1949) (explaining that the Court has "consistently refused to pervert the process of interpretation by mechanically applying definitions in unintended contexts" in a manner that would conflict with the demonstrable intent of Congress). As this Court has emphasized, "[i]nstead of balancing the various generalized axioms of experience in construing legislation, regard for the specific history of the legislative process that culminated in the Act now before us affords more solid ground for giving it appropriate meaning." *United States* v. *Universal C.I.T. Credit Corp.*, 344 U.S. at 222 (Frankfurter, J.).

provision in Section 1023(e)(3)(B) of the 1986 Act applies (as the regulation states) to "all" changes in reserve estimates. H.R. Conf. Rep. No. 841, *supra*, at II-367.

The Treasury Regulation that interprets the language of Section 1023 faithfully honors the crucial distinctions that occupied the attention of Congress in enacting the statute. The interpretation proposed by petitioner ignores them.

Petitioner observes (Pet. Br. 29) that Congress *could* have provided an express definition of the term "reserve strengthening" in the text of Section 1023(e)(3)(B). That observation, however, sheds no light on the proper meaning of that term. It merely points out why it was appropriate and helpful for the agency to issue an interpretive regulation that explains the ambiguous text of the statute. See note 12, *supra*. In issuing that regulation, the agency properly respected the textual distinctions that Congress employed and correctly gave "great weight" to the Conference Committee Report in ascertaining the intent of the legislation (*National Ass'n of Greeting Card Publishers* v. *United States Postal Service*, 462 U.S. at 832 n.28).

4. *By honoring the clear legislative intent, the regulation provides a reasonable interpretation of the statute.* This Court has emphasized that "[t]he choice among reasonable interpretations is for the Commissioner, not the courts." *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. at 488. The court of appeals properly rejected petitioner's contention (Pet. Br. 45-49) that the regulation is not "reasonable" because it produces "anomalous" and "inequitable" results (Pet. App. A23-A25). As the court

observed (*id.* at A23-A24), the broad definition of "reserve strengthening" provided by the regulation reflects Congress's intent. "[W]e as judges cannot override the specific policy judgments made by Congress in enacting the statutory provisions with which we are here concerned." *United States* v. *Sotelo*, 436 U.S. 268, 279 (1978).

Petitioner nonetheless asserts that various hypothetical applications of the regulations could result in a determination that "reserve strengthening" has occurred even when no actions concerning "reserve" calculations occurred. Before discussing the alleged defects resulting from such hypothetical applications of the regulation, however, we note that petitioner has not suggested—much less demonstrated—that any of the supposed defects have any practical relevance in the calculation of its tax liability. Petitioner is thus not a proper plaintiff to assert that such hypothetical applications of the regulation are unreasonable.

Petitioner's hypothetical objections to the regulation are, in any event, incorrect. Petitioner addresses only one example of what it deems to be an "unreasonable" result. Petitioner asserts that it is "unreasonable" to define "reserve strengthening" to include the situation in which the insurer pays more for a claim in 1986 than it had reserved for the claim in 1985 (Pet. Br. 47). Petitioner is of the view that this event would have nothing whatever to do with an increase in reserve strength. The stipulation in this case, however, reflects that this fact pattern often (if not ordinarily) *would* occur in connection with an increase in reserves of the type that would constitute

"reserve strengthening" under the statute and regulation. The stipulation explains that (J.A. 37)

> the applicable loss reserve on an individual claim [is automatically debited] whenever a payment [is] made on the claim [and,] as part of approving the payment, the responsible claim adjuster * * * determine[s] whether an adjustment should be made to the loss reserve applicable to the claim.

A payment of an amount in excess of the amount reserved would thus appropriately be accompanied by an increase in the case reserve for that claim, with the reserve then being "reduced to zero" by the payment. *Ibid.* The result is that the reserves for the claim are either actually or constructively "strengthened" at the time of the payment, and then dissipated ("reduced to zero") by the payment.[24]

Moreover, in objecting to this and similar hypothetical examples of what are claimed to be unreasonable applications of the regulation, petitioner ignores

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[24] The definition of "reserve strengthening" for pre-1986 accident years is the amount by which the total reserves for those accident years at the end of 1986 plus the payments on claims for those years made during 1986 exceed the total reserves established for those years at the end of 1985. 26 C.F.R. 1.846-3(c)(3). See H.R. Conf. Rep. No. 841, *supra*, at II-367. For example, if no reserve existed at the end of 1985 for a claim paid in 1986, reserve strengthening could exist under the regulation in the amount of the payment. That application of "reserve strengthening" is consistent with the fact that case reserves would be either constructively or actually increased by the insurer in 1986 at the time of the payment. See J.A. 37. On the other hand, if IBNR ("incurred but not reported") reserves were reduced at the time of payment (see notes 25-27 and accompanying text, *infra*), no reserve strengthening would occur under the regulation.

the consequences that such events may have on the calculation of the IBNR reserve for claims "incurred but not reported." Even the facts recited in the above example would *not* result in "reserve strengthening" under the regulation if, as the stipulation describes, the insurer estimates its "IBNR reserves by estimating ultimate losses to be incurred for an accident year * * * then subtracting paid losses to date and case estimates of reported losses" (J.A. 31). For an insurer using that method of determining IBNR, that reserve account is decreased by the amount of the payment but increased by the amount of any case reserves written off.[25] If payment is made on a claim in an amount in excess of the established case reserve, and no corresponding increase to the case reserve occurs,[26] then (i) the IBNR reserve for the

[25] For example, if an insurer that has IBNR reserves of 2000 and a case reserve for one claim in the amount of 500 made a payment on that claim of 800, if no change were made in the case reserve, the IBNR reserve would be reduced to 1700 (2000 - 800 + 500). By contrast, if a payment were made on the claim that equalled the established case reserve, there would be no change in IBNR (2000 - 800 + 800).

[26] Petititioner does not dispute that "reserve strengthening" (as explained in the Conference Committee Report and defined in the regulation) occurs when the payment is accompanied by a corresponding increase in the case reserves. Petitioner asserts only that it is unreasonable to describe a situation not involving an actual change in reserves as "reserve strengthening." In making that assertion, however, petitioner and its experts focus only on case reserves and do not consider IBNR. Indeed, one of the hypotheticals that petitioner cites (Pet. Br. 47) involves the abstraction of an insurer who "estimates zero IBNR and whose total reserves are comprised solely of aggregate case reserves" (J.A. 86). Because that hypothetical fails to give any consideration to IBNR, it asserts that the establishment of a new case reserve would evidence "reserve strengthening" (*ibid.*). But, as new reserves are established when incurred claims are reported, the ordinary result is an ultimate reduction in the reserve for claims incurred but *not* reported (IBNR reserves). Such offsetting changes would *not* produce "reserve strengthening." It is only by ignoring IBNR that petitioner's hypotheticals yield the "absurd" consequences of which it complains.

insurer would diminish by the amount by which the payment exceeded the case reserve, (ii) the total reserves at the end of the period would also decrease by that amount and (iii) thus no "reserve strengthening" would occur under the regulation.[27] Petitioner's concern over hypothetical misapplications of the regulation thus fails to take into account the fact that adjustments in IBNR may follow from payments in excess of prior reserve amounts—and that those adjustments may offset the payment and accompanying changes in other reserves and result in no reserve strengthening under the regulation.

Moreover, the court of appeals correctly concluded (Pet. App. A23) that petitioner's "anomalous results" argument is based on an unrealistic example. Petitioner's hypothetical (derived from the opinion of the Tax Court majority in *Western National*) assumes that an insurer's claims are resolved in 1986 by payment of an amount that is significantly above the

[27] That is because total reserves equal case reserves plus IBNR plus loss adjustment expense reserves. See page 2, *supra*. If IBNR were diminished by the amount of the payment in excess of the case reserve (see note 25, *supra*), then total reserves would be reduced by the amount of the payment (because the reduction in IBNR plus the reduction in the case reserve to zero when the claim is paid (J.A. 37) would equal the amount of the payment). Because total reserves are reduced by the amount of the payment, no "reserve strengthening" occurs under the regulation. See note 24, *supra*.

amount reserved for it. In reality, however, a company would resolve hundreds or thousands of claims in each year. Some will be resolved at amounts in excess of their reserves; some will be resolved at amounts less than their established reserves. As a result, the "law of large numbers" (M. Dorfman, *Introduction to Insurance* 9 (3d ed. 1987)) would operate to make the Commissioner's definition of "reserve strengthening" appropriate even in the absence of directly compensating adjustments in IBNR or elsewhere in the insurer's reserve accounts. If reserves are correctly estimated, there is no *a priori* reason to assume that claims resolved by payment of amounts in excess of the amounts reserved would dramatically exceed claims resolved by payment of amounts below the amounts reserved.

As the court of appeals concluded (Pet. App. A24 n.13), the challenged regulation would be a "reasonable" implementation of the statutory command even if it did not anticipate every conceivable permutation of possible facts. See *Mourning* v. *Family Publications Service, Inc.*, 411 U.S. 356, 371 (1973). The regulatory definition of "reserve strengthening" coincides exactly with the definition of that term contained in the Conference Report. The regulation thus provides a "reasonable" interpretation precisely because it faithfully adheres to the text and clear history of the statute. The consequences that petitioner incorrectly labels as "absurd" are, in any event, simply the consequences that Congress intended by adopting a prophylactic, "cook-book" rule. See note 14, *supra*. Although petitioner and other opponents of that legislation view the statutory "approach" as "simplistic" and "inappropriate" (*ibid.*), Congress obviously reached a different conclusion,

for it rejected that very criticism in enacting the statute. As this Court observed in *United States* v. *Correll*, 389 U.S. at 306-307 (footnotes and internal quotation marks omitted):

> Alternatives to the Commissioner's * * * rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. * * * In this area of limitless factual variations, it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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In the
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October Term, 1997

ATLANTIC MUTUAL INSURANCE CO. AND INCLUDIBLE SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari
To The United States Court of Appeals
For The Third Circuit

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INTRODUCTION

Petitioner's position in this case is straightforward: The term "reserve strengthening" in section 1023(e)(3)(B) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986), (the "1986 Act") should be interpreted in accordance with its established tax law definition and consistent with its undisputed meaning in comparable 1984 legislation. The legerdemain throughout respondent's brief does not provide a basis for rejecting that straightforward statutory interpretation.

ARGUMENT

1. *Respondent's fallacious premise.* The fundamental premise in respondent's brief is his position that the Conference Committee in 1986 expressly "rejected" the definition of "reserve strengthening" espoused by petitioner.

(R. Br. at 8, 13, 22, 23, 24, 31, 32, 33 and 34.)[1] In this regard, respondent points to a sentence in the "reserve strengthening" provision of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 216(b)(3)(A), 98 Stat. 494, 758 (1984), (the "1984 Act") (and in the Senate version of the "reserve strengthening" provision of the 1986 Act) that was omitted in the final version of the 1986 Act and argues that the omission of that sentence demonstrates that Congress expressly "rejected" in the final version of the 1986 Act the established tax definition of the term "reserve strengthening." (*See, e.g.*, R. Br. at 32.)

Petitioner's opening brief explains the meaning of the omitted sentence and why the inclusion or exclusion of that sentence could not have changed the general definition of "reserve strengthening" in the statutes in question. (P. Br. at 38-42.) As explained in petitioner's opening brief, (P. Br. at 40), Congress clearly designated the sentence in question in the 1984 Act as a special rule related to *newly issued* contracts. Both the caption in the Senate version of the bill and the use of the term "issued" in the sentence establish that the sentence applied only to contracts issued in 1983.[2] Thus, even if respondent were correct in asserting that the term "reserve strengthening" did not have an established meaning in insurance tax precedents (which he is not, as explained in petitioner's opening brief at 15-20 and *infra* pp. 5-9), the

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[1] Respondent's brief on the merits filed in this case is cited herein as R. Br. at ____. Petitioner's opening brief filed in this case is cited herein as P. Br. at ____. The Joint Appendix filed with petitioner's opening brief is cited herein as Jt. App. at ____. The Stipulations of Fact filed with the Tax Court are cited herein as Stip. ¶ ___.

[2] Respondent conveniently edits out the word "issued" when quoting the sentence in question in the text of his brief. (R. Br. at 31.) *See* 1984 Act § 216(b)(3)(A).

sentence regarding reserving practices could not have provided any definition for the term, because Congress clearly included that sentence as a limited exception to the "reserve strengthening" provision with respect to certain reserves for newly issued contracts.[3]

Apart from his misinterpretation of the special rule in the deleted sentence, respondent attempts to support his argument that the Conference Committee specifically "rejected" the definition of "reserve strengthening" espoused by petitioner by misstating the contents of the Conference Report, H.R. Rep. No. 99-841 (1986) *reprinted in* 1986 U.S.C.C.A.N. 4075. (R. Br. at 22-23.) Respondent's brief states that "the *Conference Committee emphasized that* '[t]he *conference agreement modifies* the Senate amendment with respect to the treatment of reserve strengthening' *and provides* a more expansive definition of that term than the Senate Finance Committee had provided." (R. Br. at 23

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[3] Respondent suggests that petitioner's interpretation of the term "reserve strengthening" in the 1984 Act would eliminate any need for an explicit exception with respect to reserves for certain contracts issued in 1983. (R. Br. at 33 n.22.) Respondent's vague suggestion does not withstand analysis. Respondent assumes incorrectly that the tax definition of "reserve strengthening" is not ordinarily applicable to newly issued contracts. As evidenced in the House and Senate Reports for the 1984 Act, the term "reserve strengthening" applied to reserves on new contracts that were based on new assumptions or methodologies in the absence of a specific rule to the contrary. H.R. Rep. No. 98-432, at II-1440 (1984) *reprinted in* 1984 U.S.C.C.A.N. 697, 1085; S. Rep. No. 98-169, at I-568 (1984); *see also* I.R.C. § 807(f)(1) (1986) (specifically limiting the "reserve strengthening" rule in that provision to "contracts issued before the taxable year").

(emphasis added).)[4] It is true, as discussed in petitioner's opening brief, (P. Br. at 43), that the Conference Report states that the conference agreement *modified* the *treatment* of "reserve strengthening." H.R. Rep. No. 99-841, at II-367. However, *nowhere* in the Conference Report (or anywhere else) did the Conference Committee state, as asserted in respondent's brief, that the conference agreement "provides a more expansive definition" of the term "reserve strengthening," and respondent's assertion is flatly wrong.[5]

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[4] Respondent proceeds to conjure up a theory that Congress expanded the definition to address widespread tax-motivated manipulation of loss reserves in property and casualty insurance. (R. Br. at 23-24.) In this regard, respondent refers to several sources that are not in the record in this case to support the assertion that loss reserves are easily manipulated and that such manipulation could have occurred in 1986 for tax-motivated reasons. (R. Br. at 12, 25-26.) None of those sources, however, suggest that such manipulation occurs as the result of normal reserving practices rather than changes in assumptions or methodologies. Moreover, the conclusions in two of the "sources" (one of which was a "working paper") indicate that the data does not necessarily support the irrelevant (to this case) theories espoused therein (in one case the far-fetched theory that the tax law was the cause of the liability insurance crisis of the 1980s). Of course none of respondent's inappropriate references under any circumstances addresses the core question that respondent avoids: If Congress meant to capture all increases, why didn't it just say so?

[5] Respondent also points to language in the Tax Court's opinion in this case in support of the argument that the Conference Committee expanded the definition of the term "reserve strengthening." (R. Br. at 5, 22.) In *Western National Mutual Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd*, 63 F.3d 90 (8th Cir. 1995), the reviewed Tax Court opinion, the court did *not* conclude that the Conference Report expanded the definition of "reserve strengthening." Instead, the majority of the Tax Court determined that the legislative history of the 1986 Act was contradictory and could not override the intent of Congress as expressed in the plain language of the statute. *Id.* at 360.

2. *The established tax definition of "reserve strengthening."* Despite having previously acknowledged that "reserve strengthening" had a clear meaning when applied to life insurance companies and to life reserves, *Atlantic Mutual Ins. Co. v. Commissioner*, 71 T.C.M. (CCH) 2154, 2159 (1996), *rev'd*, 111 F.3d 1056 (3d Cir. 1997); *Western National Mutual Ins. Co. v. Commissioner*, 102 T.C. 338, 353 (1994), *aff'd*, 63 F.3d 90 (8th Cir. 1995), respondent now argues that the precedents do not support a conclusion that there is a single definition of the term "reserve strengthening" even in the life insurance context. (R. Br. at 27.) Respondent's newfound contention that the term "reserve strengthening" has not been used in insurance tax law to mean only those additions to reserves that involve changes in assumptions or methodologies, (R. Br. at 26-31), is unsupportable in the face of all of the authorities to the contrary. (*See* P. Br. at 15-19.) It merits a reply primarily to show the lengths to which respondent has gone to engineer a response to one of the key points in petitioner's brief.

Respondent states that the regulation under section 810 of the Internal Revenue Code of 1954 uses the term "reserve strengthening" only in a caption and that the "term was not thereafter defined or even mentioned in the text of that regulation." (R. Br. at 27.) For this purpose, respondent conveniently ignores the use of the term in the examples that are included in the regulations under section 810 (as well as in the regulations under section 809 and in examples in the regulations under section 806). Treas. Reg. §§ 1.806-4(b) *Example 1* (1961); 1.809-5(a)(5)(iii) (1961); 1.810-3(b) *Example 2* (1961); 1.810-3(f) *Examples 2 and 3* (1961).

Respondent then resorts to, among other things, the artful use of an incomplete quotation from an example in the Treasury regulations in order to manufacture authority for his

untenable position that "reserve strengthening" is not limited to increases in reserves involving changes in assumptions or methodologies. Respondent states that "[t]he regulation issued provides an example of how that statute applied in the context of 'reserve strengthening *attributable to the change in basis*' (26 C.F.R. 1.810-3(b), Ex. 2) (emphasis added)." (R. Br. at 27 n.16.) With his selective quotation of the regulations, respondent implies that the regulations fairly could be read to mean that "reserve strengthening" under section 810(d) can be attributable to things other than a change in basis. Indeed, respondent goes on to state: "A change in reserves that results from a change in 'the basis' of setting reserves, is, of course, only one type of 'reserve strengthening.'" (R. Br. at 27.)

The portion of the regulations respondent partially quotes actually states as follows:

> Under the provisions of section 810(d)(1), as a result of the *reserve strengthening attributable to the change in basis which occurred in 1959*, L would include $5 (computed in the manner described in example (1)) as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809-5 in determining its gain or loss from operations for 1960.

Treas. Reg. § 1.810-3(b) *Example 2* (1961). The complete regulatory language on which respondent focuses thus simply is trying to show that one tenth of L's 1959 reserve increase caused by a change in basis which occurred in 1959 ($50 per example (1)) must be taken into account in determining gain or loss from operations in 1960. It nowhere suggests that

"reserve strengthening" may be attributable to something other than a change in basis in computing reserves.

Respondent later states in this section of his brief that:

> [u]nlike the statute involved in the present case, the narrow focus of Section 810(d)(1) in the Life Insurance Company Tax Act of 1959 was only on changes in "the basis" of accounting for reserves. That statute, by its terms, did not purport to apply broadly to all "reserve strengthening" actions and the concept of "reserve strengthening" does not even appear in the statutory text.

(R. Br. at 28.) In so stating, respondent apparently ignores one of his own recent rulings in which he states that:

> [i]n the legislative history of the 1959 Act, the term "basis" is used interchangeably with "method" when describing the effects of a change in basis of computing reserves.

Rev. Rul. 94-74, 1994-2 C.B. 157. The legislative history to which the ruling refers expressly ties changes in method to "reserve strengthening":

> **(d) Adjustment for change in computing reserves.**--Subsection (d) of section 810, which is identical with the House bill, deals with the effect on deductions for increases in reserves (or amounts included in income for decreases in reserves) where there have been changes in the method of computing the

> reserves. Paragraph (1) refers to what is generally described as reserve strengthening. This paragraph provides in the case of reserve strengthening that the additional deduction which would otherwise be allowable because of additions to reserves occurring in this strengthening process is to be taken into account ratably over a 10-year period rather than in a single year.

S. Rep. No. 86-291 (1959) *reprinted in* 1959 U.S.C.C.A.N. 1575, 1632-33. It simply is disingenuous at this stage for respondent to change his story about the meaning of the term "reserve strengthening" in the case of life insurance. *See Western National*, 102 T.C. at 352 ("Respondent acknowledges that the term 'reserve strengthening' has a commonly understood industry meaning in the life insurance area . . ."); *Id.* at 353 ("Respondent agrees that the use of reserve strengthening in connection with [the 1984 Act] was in accord with life insurance industry usage . . ."); *Atlantic Mutual*, 71 T.C.M. at 2159 ("Respondent acknowledges that, in the life insurance industry, the term 'reserve strengthening' has the meaning petitioner ascribes to it.").

Also to be noted are respondent's nimble changes in his frame of reference. (R. Br. at 26-31.) He flitters from insurance tax precedents to insurance industry precedents to life insurance precedents to property and casualty insurance precedents in an effort to confuse the clear meaning of the term "reserve strengthening" in the insurance tax law. Respondent simply has no direct response to the income tax precedents cited in petitioner's brief which clearly establish that "reserve strengthening" means "additions required when a method or assumption used in calculating policy reserves is changed so as to produce a higher reserve." *Jefferson*

Standard Life Ins. Co. v. United States, 272 F. Supp. 97, 121 (M.D.N.C. 1967), *aff'd in part, rev'd in part, and remanded*, 408 F.2d 842 (4th Cir. 1969).

That there has long been an established tax law definition of the term "reserve strengthening" is reinforced by the fact that Congress did not feel any need to provide a definition for the term. The House version of the 1984 Act contained a "reserve strengthening" provision with no attempt to define the term "reserve strengthening" for any purpose. The Senate version of the 1984 Act added the sentence discussed *supra* pp. 1-4 regarding reserve practices, but that sentence was intended to provide a special exception to the "reserve strengthening" provision that applied only to reserves for certain contracts issued in 1983. Neither the Senate version nor the final version of the 1984 Act included a general definition of the term "reserve strengthening." Nor did Congress direct respondent to issue regulations to provide such a definition, and, in fact, respondent never promulgated any such regulations. Thus, it seems apparent that all those involved in drafting and implementing the "reserve strengthening" provision in the 1984 Act had a clear understanding of the insurance tax meaning of the term.

In sum, as explained in petitioner's opening brief, (P. Br. at 15-19), there is an established tax law definition of the term "reserve strengthening." That definition surely was what a careful Congress would have had in mind in using the term in the 1986 Act. In fact, there is no tax authority whatever for respondent's sweeping regulatory definition of "reserve strengthening."

3. *The expert testimony.* Respondent falsely asserts that petitioner's position and the Tax Court's holding are based on industry practice that provides the definition for the

term "reserve strengthening" in section 1023(e)(3)(B) of the 1986 Act. (R. Br. at 4, 18.) Petitioner, the Tax Court, and the Eighth Circuit all base their conclusion regarding the meaning of the term "reserve strengthening" on the established *tax law* definition of the term. Petitioner observed in its brief that all of the experts accepted the established tax law definition as a valid interpretation of the term "reserve strengthening" in property and casualty insurance. Petitioner referred to the experts merely to show that the term "reserve strengthening" is used in property and casualty insurance to mean an increase in loss reserves involving a change in assumptions or methodologies. (P. Br. at 27-28.)

In discussing the Tax Court's analysis in *Western National*, respondent states that "[t]he majority relied on the taxpayer's expert witnesses in concluding that the term 'reserve strengthening' has an 'industry meaning' that is narrower than the definition contained in the agency's regulation." (R. Br. at 4.) However, the expert testimony in *Western National* was not central to the Tax Court's analysis in that case. In fact, the Tax Court's only reference to the expert testimony in its opinion in *Western National* is in a single footnote. 102 T.C. at 351 n.10. The Tax Court's analysis in *Western National* instead was centered on the established definition of "reserve strengthening" in insurance tax precedents and on Congress' stated objective to prevent "artificial" reserve increases. *Id.* at 351-54, 356. Thus, respondent's effort to shift the focus of this case (presumably because he finds comfort in the absence of a universally-

recognized single industry meaning) contributes nothing to the inquiry.[6]

4. *Loss reserves and life reserves.* Respondent, like the Third Circuit, attempts to draw a distinction between the taxation of life insurance companies and of property and casualty insurance companies, as well as between loss reserves and life reserves.[7] The dichotomy respondent attempts to create simply does not exist, as explained at

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[6] Respondent attempts to blunt the impact of the expert testimony that is favorable to petitioner by suggesting that *both* "government witnesses stated that the definition proposed by petitioner's expert 'is a restricted definition and is not the most commonly understood definition' of reserve strengthening (J.A. 191)." (R. Br. at 19 n.8.) However, as is evidenced by respondent's single citation to the Joint Appendix, only one of respondent's experts, Raymond Nichols, said that petitioner's definition of "reserve strengthening" was restricted; respondent's other expert, Ruth Salzmann, reached no such conclusion. (Jt. App. at 165-81, 201-13.)

[7] In attempting to create a dichotomy between the taxation of life insurance companies and of property and casualty insurance companies, respondent selectively quotes *Alinco Life Ins. Co. v. United States*, 373 F.2d 336, 352 (Ct. Cl. 1967), as follows: "tax provisions relating 'primarily to casualty-type insurance * * * are rather meaningless in pure life insurance[.]'" (R. Br. at 30.) That quoted material in fact relates only to unearned premiums and unearned premium reserves of casualty insurance companies. A fair quote would read as follows:

> The testimony of Alinco's expert actuary, Arthur C. Eddy, is entirely persuasive that these technical terms [*i.e.*, unearned premiums and unearned premium reserves] refer primarily to casualty-type insurance and are rather meaningless in pure life insurance.

Alinco, 373 F.2d at 352. Clearly, the court in that case did not suggest that all terms used in property and casualty insurance are meaningless in life insurance or that all terms used in life insurance are meaningless in property and casualty insurance.

length in petitioner's opening brief. (P. Br. at 34-38.) There is no difference between the two types of reserves or the taxation of the two types of companies that is relevant to this case. (P. Br. at 34-38.) Significantly, respondent ignores the fact that section 846 of the Internal Revenue Code of 1986, to which the "reserve strengthening" provision in the 1986 Act relates, applies *both* to life insurance companies and to property and casualty insurance companies. In this connection, respondent never even acknowledges that, at the time the 1986 Act became law, a company taxed as a life insurance company that changed its method of computing loss reserves from an undiscounted basis to a discounted basis already was subject to the "reserve strengthening" provisions of section 807(f) (previously section 810(d)) and that his interpretation of section 1023(e)(3)(B) of the 1986 Act would subject a life insurance company's changes in loss reserves to two different interpretations of the term "reserve strengthening." (P. Br. at 21 n.9, 30.)

5. *The legislative history.* Respondent argues that the "reserve strengthening" regulation "faithfully adheres" to the intent of the Conference Committee as expressed in the Conference Report and, therefore, should be upheld. (R. Br. at 8.) As a preliminary matter, we note that respondent's regulation does not adhere even to its own interpretation of the Conference Report. (P. Br. at 48.) In any event, as the Tax Court noted in *Western National*, the Conference Report is subject to a different interpretation.[8] 102 T.C. at 350,

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[8] The Conference Report does not state, as respondent asserts, that "all additions to reserves for pre-1986 accident years" are included in "reserve strengthening." (R. Br. at 22 n.12.) What the Conference Report actually states is that "all additions to reserves *attributable to an increase in an estimate of a reserve* established for a prior [pre-1986] (continued...)

355-56. Certainly, the Conference Report's reference to Congress' intent to prevent taxpayers from "artificially" increasing their reserves suggests that Congress intended a limited definition of the term "reserve strengthening," rather than the broad definition espoused by respondent.[9] As discussed *infra* n.14, such legislative history cannot make a

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[8] (...continued)
accident year" constitute "reserve strengthening." H.R. Rep. No. 99-841, at II-367. Respondent never tries to explain why the Conference Committee would have added the limiting language that follows the words "all additions to reserves." As discussed in the brief amici curiae filed by a number of insurance trade associations, a fairer reading of the Conference Report language, taken as a whole, is that, if in reporting its loss reserve estimates for 1986 an insurer continued to use existing reserve assumptions and methodologies, there would be no increase *in a reserve estimate* and therefore no "reserve strengthening." (Brief *Amici Curiae* of American Insurance Association, et al. at 12 [hereinafter Tr. Assoc. Br. at ____].)

Separately, respondent states in his brief that "Section 1.846-3(c)(2) of the Treasury Regulations defines 'reserve strengthening' for the 1986 accident year in exact conformity with the definition contained in the Conference Committee Report and that aspect of the regulation is not challenged in this case." (R. Br. at 22 n.12.) Respondent did not adjust petitioner's loss reserves for the 1986 accident year, so section 1.846-3(c)(2) of the Treasury regulations of course could not be at issue in this case.

[9] Respondent embraces the definition of "artificial" cited by Judge Halpern in his dissent in *Western National*, 102 T.C. at 373. (R. Br. at 25 n.15.) Judge Halpern suggests that "[a] less common definition of the word 'artificial'" *i.e.*, "artful" or "cunning," was what "the conference committee had in mind." *Id.* With due respect to Judge Halpern, the definition of "artificial" that he proposes was not simply less common; it was obsolete. *Webster's Third New International Dictionary* 124 (1986); *Webster's Ninth New Collegiate Dictionary* 106 (1985). It is difficult to believe that Congress would have had an obsolete definition of "artificial" in mind when it used the term to describe the purpose of the "reserve strengthening" provision of the 1986 Act.

statutory term ambiguous when the language of the statute is itself unambiguous.

Respondent also points to a statement Senator Wallop made (several weeks after Congress voted on the 1986 Act), 1986 U.S.C.C.A.N. 4075; 132 Cong. Rec. 32,625 (Oct. 16, 1986), as evidence that the Conference Committee embraced a broad definition of "reserve strengthening" that is consistent with respondent's regulation. (R. Br. at 23.) In this connection, respondent conveniently ignores Senator Wallop's complaint at the beginning of his statement that he was troubled by the impact of "staff decisions" with respect to "issues never formally considered by the conferees." 132 Cong. Rec. 32,625 (October 16, 1986).

In any event, respondent's only support for considering the statement of Senator Wallop is a case which holds that statements of individual legislators are evidence of Congress' intent "when they are consistent with the statutory language and other legislative history" of a statutory provision. *Brock v. Pierce County*, 476 U.S. 253, 263 (1986). The authority cited by respondent also states that "[s]uch statements by individual legislators should not be given controlling effect . . . ." *Id.* Thus, an individual legislator's statement cannot properly be used to create ambiguity when the language of a statute is unambiguous. Moreover, Senator Wallop's statement is not clearly consistent with the other legislative history of the 1986 Act, because that legislative history is subject to more than one interpretation. *See supra* n.8. Accordingly, Senator Wallop's post-enactment statement should have no bearing on the Court's determination of the meaning of the term "reserve strengthening" as used in the 1986 Act.

6. *The regulation's unreasonable results.* In responding to illustrations of absurd and inequitable outcomes that the regulation produces, respondent contends, (R. Br. at 36-40), that "compensating adjustments" in IBNR or elsewhere in the insurer's reserve accounts should always operate to make the definition of "reserve strengthening" in the regulation reasonable.[10] However, despite respondent's arguments to the contrary, there are no automatic "compensating adjustments" to the unreasonable results under the regulation.[11]

Respondent first manufactures the concept of a "constructive reserve" in an effort to defend the reasonableness of the regulation. Respondent bases his constructive reserve analysis on a misreading of a factual stipulation concerning petitioner's method of accounting for loss payments. (Jt. App. at 37, Stip. ¶ 37.) Respondent reads that stipulation to say that "[a] payment of an amount in excess of the amount reserved would thus appropriately be accompanied by an increase in the case reserve for that

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[10] Respondent states that "[p]etitioner addresses only one example of what it deems to be an 'unreasonable' result." (R. Br. at 36.) There are other examples of unreasonable results, referred to in petitioner's brief (P. Br. at 47, 49), that the regulation produces that can be found in the report of Irene Bass, (Jt. App. at 79, 86), in the report of James MacGinnitie, (Jt. App. at 107-108), and in the trade association brief, (Tr. Assoc. Br. at 16-17). Respondent has chosen not to address the unreasonable results described in those sources.

[11] Respondent repeatedly refers to the absurd and inequitable results produced by his interpretation of the term "reserve strengthening" in the regulation as involving "hypothetical" applications of the regulation. (R. Br. at 35-40.) In this connection, it is to be noted that the trade association brief sets forth anomalous situations "frequently faced by member companies." (Tr. Assoc. Br. at 16-18.)

claim, with the reserve then being 'reduced to zero' by the payment." From that, respondent suggests that there was an implicit reserve increase whenever petitioner paid more for a claim in 1986 than it reserved for it in 1985.

The stipulation to which respondent refers does not say that petitioner ever increased a reserve in respect of a closed claim. It is clear from a proper reading of the stipulation that petitioner adjusted reserves only when it made partial claim payments on *open* claims. If a payment exceeded the case reserve being carried on a claim at the time the claim was closed, petitioner would charge such excess to *expense*, not to a "constructive" reserve that was simultaneously created and eliminated through offsetting entries. Respondent's concept of a "constructively strengthened" reserve is nonsense. The question therefore remains: How can a taxpayer be treated as having strengthened its year-end 1986 reserves for a claim which was fully paid in 1986 and for which no reserve could exist as of the end of 1986?

Respondent separately contends that petitioner's 1986 payments on a claim in excess of the 1985 reserve for the claim would not produce "reserve strengthening" under the regulation "if as the stipulation describes, the insurer estimates its 'IBNR reserves by estimating ultimate losses to be incurred for an accident year * * * then subtracting paid losses to date and case estimates of reported losses' (J.A. 31)." (R. Br. at 38.) Significantly, not all insureds follow the IBNR computation approach posited by respondent. Indeed, despite the contrary implication respondent creates in his brief through his selective quotation of the stipulation, (Jt. App. at 31, Stip. ¶ 20), the record in this case shows that *petitioner did not compute its IBNR in that manner*, (Jt. App. at 34-35, Stip. ¶ 30), and, therefore,

respondent's contention (which in any event is incorrect[12]) is irrelevant in this case.

7. *The inapplicable deference principle.* Respondent cites several cases for the proposition that courts must defer to respondent's interpretation of tax statutes. In light of this Court's decision in *Chevron U.S.A, Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984), deference to respondent's interpretation may be appropriate if the statutory language is ambiguous. But, as the Tax Court held in *Western National*, consistent with *Chevron*, "This case presents a different perspective because the statute is neither ambiguous nor imprecise." 102 T.C. at 360 n.25.

Respondent asserts that the meaning of the term "reserve strengthening" as used in the 1986 Act is not plain or unambiguous if resort must be had to other statutes and tax precedents to find meaning. Respondent cites *Sullivan v. Stroop*, 496 U.S. 478, 482 (1990) (*quoting K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291-292 (1988)), for the proposition that plain meaning must be ascertained by looking to "'the particular statutory language at issue, as well

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[12] Respondent includes an incomprehensible example in his brief that appears to try to show that a 1986 claim payment in excess of the 1985 case reserve for the claim would necessarily result in a decrease in IBNR and therefore would prevent "reserve strengthening" from occurring under the regulation. Respondent arbitrarily (and incorrectly) assumes in his example that the insurer's estimate of ultimate incurred losses at the end of 1986 would be the same as it was at the end of 1985, despite the 1986 payment in excess of the case reserves. From this respondent draws the incorrect conclusion that "[i]t is only by ignoring IBNR that petitioner's hypotheticals yield the 'absurd' consequences of which it complains." (R. Br. at 39 n.26.) But, it is only by improperly ignoring the impact on an insurer's total loss estimate of a 1986 claim payment in excess of the 1985 case reserve for the claim that respondent's illustration can be shaped to avoid absurd results.

as the language and design of the statute as a whole.'" (R. Br. at 17-18.) Respondent suggests that if *any* resource (except possibly the dictionary) outside statutory language is utilized, the statute cannot have a plain meaning. (R. Br. at 19-20.)

While it is true that the 1986 Act does not provide a definition of "reserve strengthening," the plain meaning of a term can be supplied, for example, by repeated use of the term in insurance tax precedents in a consistent manner or by consistent prior use in a virtually identical statutory setting. It is simply incorrect to limit the boundaries of a plain meaning inquiry to what appears on the face of the statute without considering such prior usage. *See, e.g.*, *Commissioner v. Lundy*, 516 U.S. 235, __, 116 S. Ct. 647, 655 (1996); *Brown v. Gardner*, 513 U.S.115, __, 115 S. Ct. 552, 555 (1994); *Commissioner v. Keystone Consolidated Industries, Inc.*, 508 U.S. 152, 159 (1993); *see also Pierce v. Underwood*, 487 U.S. 552, 568 (1988). Even in *Stroop*, the Supreme Court did not apply such an overly limited method of determining plain meaning. Instead, the Court looked for the commonly accepted definition of "child support" as used in domestic relations law, taking into account the definition provided in Black's Law Dictionary *and* the consistent definition of the term as used in other parts of the Social Security Act.[13] *Stroop*, 496 U.S. at 482, 484.

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[13] Respondent also relies on a statement made by the Supreme Court in *Greensport Basin & Construction Co. v. United States*, 260 U.S. 512, 516 (1923): "As the language of the act is clear, there is no room for the argument of plaintiff drawn from other revenue measures." In cases subsequent to *Greensport Basin*, the Supreme Court has clearly demonstrated that it can look to the use of a term in other statutes, as well as to the context of the statutory structure as a whole, to ascertain the plain meaning of a statutory term. *See, e.g., Brown v. Gardner*, 513 U.S. at __, 115 S.Ct. at 555 (1994), and other cases cited in petitioner's brief.
(continued...)

Respondent's reliance on *TVA v. Hill*, 437 U.S. 153, 184 n.29 (1978), for the general principle noted above, and *Florida Power & Light Co. v. Lorion*, 470 U.S. 729, 737 (1985), also is misplaced. Those cases did *not* involve a statute that was plain and unambiguous.

Finally, respondent questions the applicability of the principle that when Congress uses the same term in the same or closely related statutes the term should be interpreted consistently. Respondent argues that the principle does not apply in this case because "Congress used different language in different contexts to address different subjects in these statutes." (R. Br. at 33.) As petitioner demonstrated in its opening brief, however, the term "reserve strengthening" was used in the 1984 Act and the 1986 Act in virtually identical provisions in virtually identical contexts to address virtually identical subjects.[14] (P. Br. at 20-25.)

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[13] (...continued)
(P. Br. 15.) Further, *Greensport Basin* is inapposite because that case did not involve the use of an identical term in separate statutes. Simply put, the quotation is clearly taken out of context and the government's reliance on it is misplaced.

[14] Respondent also suggests that the principle of consistent interpretation of statutory terms is merely a presumption which is overcome in this case by the Conference Report. (R. Br. at 33 n.23.) The authority cited by respondent is inapposite. It does not involve consistent interpretation of the same term in closely related statutes, but rather an attempt to import the meaning of a term as used in state statutes dealing with insurance into a federal statute dealing with banking, clearly not closely related statutes. *NationsBank of North Carolina, N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995). Moreover, even if respondent were correct, the Conference Report in this case would not be sufficient to overcome the presumption. *Pierce v. Underwood*, 487 U.S. at 568. The intent of Congress with respect to the definition of "reserve strengthening" is not made clear by the Conference Report. As explained
(continued...)

CONCLUSION

For the reasons set forth above and in petitioner's opening brief, the Court should reverse the judgment of the Court of Appeals for the Third Circuit and reinstate the judgment of the Tax Court.

Respectfully submitted,

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[14] (...continued)
in petitioner's opening brief, the language indicating that the Conference Committee was changing the *treatment* of "reserve strengthening," not making changes to the *definition* of the term, and the intent of Congress to prevent "artificial" reserve increases raise substantial questions about the meaning of the Conference Report. (P. Br. at 43-45; Tr. Assoc. Br. at 15-16.) Thus, the ambiguous Conference Report cannot overcome the unambiguous language of the statute.

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No. 97-147

In the
Supreme Court of the United States
October Term, 1997

ATLANTIC MUTUAL INSURANCE CO.
and Includible Subsidiaries,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the
United States Court of Appeals
for the Third Circuit

BRIEF AMICUS CURIAE OF AMBASE CORPORATION IN SUPPORT OF PETITIONER

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BRIEF AMICUS CURIAE
OF AMBASE CORPORATION
IN SUPPORT OF PETITIONER

AmBase Corporation[1], with the consent of all parties, submits this brief amicus curiae pursuant to Rule 37.3 of the Rules of this Court in support of petitioner Atlantic Mutual Insurance Company.

[1]Rule 37.6 disclosure: This brief amicus curiae was authored by Peter H. Winslow and Gregory K. Oyler, counsel for AmBase Corporation. There was no monetary contribution to the preparation or submission of the brief other than legal fees and expenses paid by AmBase Corporation.

INTEREST OF THE AMICUS CURIAE

Amicus AmBase Corporation is a financial holding company that in 1987 joined in filing a consolidated federal income tax return with five wholly-owned subsidiaries that were property and casualty ("P/C") insurance companies ("The Home Group"). Like petitioner, amicus' 1987 consolidated tax return was audited by respondent, and a deficiency was proposed based on respondent's assertions that The Home Group engaged in reserve strengthening in 1986. Respondent determined that in 1986 The Home Group had increases in reserves for pre-1986 accident years attributable to reserve strengthening even though The Home Group's actual reserves decreased in 1986 by over $1 billion. Amicus filed a petition in the United States Tax Court on June 7, 1996, raising legal issues that are similar to those involved here. The case presently is pending in the Tax Court. Appeal would lie in the United States Court of Appeals for the Second Circuit.

The purpose of this amicus brief is not to repeat the arguments made by petitioner. Rather, amicus brings to the Court's attention material facts that bear on the meaning of reserve strengthening in the P/C industry that are reflected in the expert reports in this case, but were misinterpreted by the Third Circuit.

SUMMARY OF ARGUMENT

The term "reserve strengthening" has a plain meaning in the tax law. Reserve strengthening occurs when an actuary makes a change in basis of computing reserves (*i.e.*, the actuary changes reserve assumptions and/or methodologies) to increase the adequacy of reserves. Section 1023 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2399 (1986)

("1986 Act"), must be read in a manner consistent with this plain meaning of reserve strengthening, and Treas. Reg. § 1.846-3(c) (the "Regulation") must be held to be invalid to the extent that it conflicts with this statutory meaning.

The Third Circuit erred in several respects in upholding the validity of the mechanical test for reserve strengthening in the Regulation.[2] The court's fundamental error is its conclusion that the term "reserve strengthening" in section 1023 of the 1986 Act is ambiguous. The term is not ambiguous because it has had a settled meaning in the tax law for many years, as evidenced by cases and IRS rulings and regulations. Congress used this same meaning of the term just two years prior to the 1986 Act in the fresh start transition rules of section 216 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 758 (1984) ("1984 Act"), applicable to both life and P/C insurers. From the context and purpose of the statute, it is clear that, in enacting the 1986 Act, Congress intended to adopt the tax definition of reserve strengthening. The fact that this tax definition of reserve strengthening is applicable to P/C insurers, as well as life insurers, is clear from The Home Group's own reserve practices — in 1985 it engaged in reserve strengthening as that term is used in the tax law. The Third Circuit was wrong to reject the settled tax definition of reserve strengthening.

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[2]In this brief, amicus will not describe the loss discounting rule of section 846 of the Internal Revenue Code of 1986 ("Code"), the "fresh start" transition rule of section 1023 of the 1986 Act, or the "mechanical test" of the Regulation. Amicus assumes that the briefs of the parties will provide the background and analysis on these matters.

The Third Circuit was led astray by its improper and erroneous factual finding that reserve strengthening has more than one meaning ***in the P/C industry***. Because of the well-established meaning of the term in the tax law, that meaning controls, and any other meaning in the P/C industry is irrelevant. There is no reason to assume that Congress intended to adopt some definition of reserve strengthening peculiar to the P/C industry when the fresh start rule of section 1023 applies equally to life and P/C insurers. In addition, it was error by the Third Circuit even to make a factual finding concerning any meaning in the P/C industry. Weighing testimony and making factual determinations is the province of the trial court; if the trial court omits a critical factual finding, the case must be remanded so that the trial court can make the factual finding or supplement the record. Further, the Third Circuit erred yet again by making a wrong finding concerning the meaning of reserve strengthening in the P/C industry. Its conclusion in this regard was based on a misreading of the expert reports. In fact, all four experts in the case agreed on the basic principle that reserve strengthening in the P/C industry is used to refer to an act to improve reserve adequacy of current reserves, resulting from a change in reserve assumptions and/or methodologies. This definition is consistent with the accepted tax law definition.

Finally, respondent's definition of reserve strengthening is unreasonable, and the Regulation is invalid, because it treats all 1986 loss payments as increases in 1986 reserves.

ARGUMENT

I. The Third Circuit Erred in Rejecting the Long-Standing Tax Definition of Reserve Strengthening

Amicus agrees with petitioner and the Tax Court that the term "reserve strengthening" has a settled meaning in the tax law. Accordingly, section 1023 is unambiguous. Reserve strengthening refers to a change in basis of computing reserves, *i.e.*, a change in reserve assumptions and/or methodologies. *E.g.*, Treas. Reg. §§ 1.806-4(b) Ex. (1), 1.809-5(a)(5)(iii), 1.810-3. This conclusion — that reserve strengthening has a well-recognized meaning in the tax law — should be the end of the inquiry.

Because of the accepted meaning of reserve strengthening in the tax law, the finding of the Third Circuit that the term has more than one meaning ***in the P/C industry*** is irrelevant to the proper interpretation of section 1023. Both respondent and the Third Circuit have missed the point that the reserve discounting rules, to which the "fresh start" transition rules of section 1023 relate, also are applicable to life insurance companies. See the last sentence of section 807(c) of the Code. For example, the reserve discounting rules, and the "fresh start" provisions, apply to reserves for cancellable accident and health insurance — an insurance coverage typically offered by life insurance companies. Presumably, it is because the reserve discounting rules apply equally to life and P/C insurers that the rules were placed in Part III of Subchapter L of the Code, applicable to both life and P/C insurers, rather than in Part II, applicable only to P/C insurers. In short, because the "fresh start" transition rule applies to both life and P/C insurers, there is no reason to assume, as the Third Circuit did, that Congress intended to

adopt some meaning of reserve strengthening peculiar to P/C insurers.[3] It is more logical to conclude that Congress intended to adopt the tax definition of reserve strengthening that previously had applied consistently to both life and P/C insurers and had been used by Congress just two years earlier in a comparable transition rule for life insurance reserves.[4]

Applicability of the tax definition of reserve strengthening to P/C insurers is demonstrated by The Home Group's reserve strengthening in 1985

A key basis of the Third Circuit's ruling is its erroneous conclusion that the "life insurance" definition of reserve strengthening is irrelevant to P/C insurers.[5] (App. at A-12 to A-13.)[6] This flawed notion is based on a series of incorrect premises. While noting that actuarial assumptions and methodologies are integral to the computation of life insurance reserves, the Third Circuit wrongly infers that actuarial assumptions and methodologies are not an important part of determining P/C reserves. This inference leads the Third Circuit to the incorrect belief, unsupported by anything in the record, that there would never be any reserve strengthening by a P/C insurer under the tax definition of the term. Based on this belief, the Third Circuit finds that it is illogical to apply the tax definition of reserve strengthening to P/C insurers.

[3]For the reasons stated later in this brief, amicus believes that reserve strengthening has the same meaning for P/C and life insurers.

[4]As in the case of section 1023, the reserve changes made by the 1984 Act, and the fresh start transition rules in section 216 of the 1984 Act, applied to both life and P/C insurers. *See* section 832(b)(4) of the Code.

[5]The Third Circuit incorrectly assumed that the tax definition of reserve strengthening was derived from a definition of reserve strengthening applicable only to life insurance companies.

[6]In this brief, page citations for the Third Circuit's opinion refer to the Appendix to the Petition for Writ of Certiorari ("App. at A-__").

In fact, as amicus would prove in its case pending in the Tax Court, actuarial assumptions and methodologies are integral to the computation of P/C reserves, and from time to time P/C actuaries make changes in these assumptions and methodologies. These facts are consistent with the testimony of the experts and the finding of the Tax Court in *Western National Insurance Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd*, 65 F.3d 90 (8th Cir. 1995), that reserve strengthening for life insurance companies has characteristics similar to reserve strengthening for P/C companies. In both contexts, reserve strengthening involves a change in reserve assumptions and/or methodologies.

Further, the actions of The Home Group provide a real-life example of reserve strengthening by a P/C insurer (as defined by the Tax Court and used in the life industry). The former chief actuary of The Home Group made a change in her reserve methodology in March 1985 that improved the adequacy of current reserves. This action was described by the companies in their public reports and in internal documents as reserve strengthening, and is fully consistent with the definition of reserve strengthening used in the life insurance industry and adopted by the Tax Court in *Western National*. The amount of

The Home Group's 1985 strengthening bears no relationship to the amount that would have been determined as reserve strengthening under the mechanical test in the Regulation. In short, amicus' own facts refute an important premise of the Third Circuit — that reserve strengthening for life companies is not analogous to reserve strengthening for P/C companies.

II. THE THIRD CIRCUIT MADE AN IMPERMISSIBLE FINDING OF FACT AS TO THE MEANING OF RESERVE STRENGTHENING IN THE P/C INDUSTRY

Because reserve strengthening has a clear meaning in the tax law, the definition of the term ***in the P/C industry*** should be irrelevant. Nevertheless, the Third Circuit made a *de novo* review of the expert reports on the P/C meaning of the term and concluded erroneously that: "The expert testimony here makes clear that the term 'reserve strengthening' as used in section 1023(e)(3)(B) is subject to more than one interpretation." (App. at A-9.) Based on this finding of ambiguity, the Third Circuit resorted to legislative history to find support for the mechanical test adopted in the Regulation.

The Third Circuit erred in making any factual finding at all concerning the meaning of reserve strengthening because the Tax Court in this case made no findings of fact as to the meaning of reserve strengthening in the P/C industry. In addition, the Tax Court made no findings as to the relative credibility of the various experts, who were not subject to cross-examination. In these respects, the record before this Court is deficient. This deficiency should not cause this Court to conclude that the term "reserve strengthening" is ambiguous. Amicus believes it could demonstrate at trial of its own case that reserve strengthening has a clear meaning. That meaning

is the tax definition — the same definition adopted by the Tax Court in *Western National*.

If the record at the trial court omits a material finding of fact, it is improper for an appellate court to make its own finding, particularly where that fact is contested. Moore's Federal Practice 3d § 206.03[6] (1997). An appellate court is not permitted to weigh conflicting testimony and make a factual determination. *Icicle Seafoods, Inc. v. Worthington*, 475 U.S. 809, 713-14 (1986); *Anderson v. Bessemer City*, 470 U.S. 564, 573-75 (1985). Rather, if the factual issue is critical to its holding, the case must be remanded to the trial court to make the factual finding, supplement the record, or to clarify its prior findings. *See Kelley v. Everglades Drainage Dist.*, 319 U.S. 415 (1943). In this case, the Third Circuit made its own finding of fact as to the meaning of reserve strengthening in the P/C industry. This was improper.[7]

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[7]Although the cases cited deal with review of district court decisions, section 7482(a)(1) of the Code provides that appellate review of a decision of the Tax Court shall be the same as that of a decision of the district courts in civil actions tried without a jury.

III. The Third Circuit Erred in Concluding that Reserve Strengthening Does Not Have a Clear Meaning in the P/C Industry

An analysis of the expert reports confirms that reserve strengthening in the P/C industry means an action taken by an actuary to improve the adequacy of current reserves, resulting from a change in reserve assumptions and/or methodologies

Unlike in the *Western National* case, the Tax Court in this case did not make a specific factual finding as to the meaning of reserve strengthening in the P/C industry. Nevertheless, the Third Circuit on its own evaluated the expert reports and concluded that they reflect several meanings of reserve strengthening in the P/C industry.[8] Amicus has engaged one of the two experts used by petitioner in this case. This expert, Irene K. Bass, has informed amicus, and amicus expects to be able to prove in a trial of its case, that the Third Circuit has misinterpreted the expert reports.

The reports of the experts reveal that a P/C actuary refers to reserves as "strong" or "weak" in a manner that is synonymous with "adequate" or "inadequate." (Report of petitioner's expert W. James MacGinnitie ("MacGinnitie Report") at 6; Report of respondent's expert Ruth E. Salzmann ("Salzmann Report") at

[8]The Third Circuit summarized its understanding of the expert reports on the meaning of reserve strengthening in footnote 5 of its opinion. (App. at A-9 to A-10.)

4.)[9] In the context of setting reserves, the term "reserve strengthening" connotes an ***action*** taken to improve the adequacy of the ***current*** reserves — the larger reserve is more adequate, or stronger. (MacGinnitie Report at 7; Salzmann Report at 6.) Therefore, a P/C actuary engages in the act of reserve strengthening (making them more adequate) when the actuary increases the reserves from what they otherwise would have been at that same point in time. Irene Bass, in her report, goes on to say that an essential characteristic of this action is a change in reserve assumptions or methodologies. (Report of petitioner's expert Irene K. Bass ("Bass Report") at 31-32.) In summary, reserve strengthening in the P/C industry means an action taken by an actuary to improve the adequacy of current reserves resulting from a change in reserve assumptions and/or methodologies.

The Third Circuit's misreading of the expert reports results from its failure to distinguish between the act of strengthening ***current*** reserves and an evaluation of the adequacy of ***prior*** reserves. This misreading may be caused by the fact that the expert reports sometimes describe prior reserves as "stronger" or "weaker" than reserves at other points in time. (*E.g.*, MacGinnitie Report at 7.) However, three of the experts agreed that any such comparison of reserves at different points does not properly measure reserve strengthening unless all subsequent developments are taken into account and total reserves are considered. (MacGinnitie Report at 7; Salzmann Report at Appendix II; Rebuttal Report of Ruth E. Salzmann re Bass Report ("Salzmann Rebuttal re Bass") at 2; Bass Report at 32-33.) Because the mechanical test of the Regulation does not

[9]In this brief, page citations for the expert reports and rebuttal reports refer to the original page numbers of those reports.

do this, the three experts (including one of respondent's experts) agreed that the mechanical test does not even attempt to measure the "strength" of reserves. (MacGinnitie Report at 9-11; Rebuttal Report of Ruth E. Salzmann re MacGinnitie Report ("Salzmann Rebuttal re MacGinnitie") at 1-4, Appendix I; Bass Report at 33-46.) Equally important, respondent's mechanical test fails to make the critical distinction between, on the one hand, the action-based concept of reserve strengthening, which involves an ***intentional act*** by an actuary to increase the adequacy of ***current*** reserves and, on the other hand, an ***after-the-fact comparison*** of whether reserves turned out to be "stronger" or "weaker" than ***earlier*** reserves. As respondent's own expert recognized, a layman sometimes incorrectly concludes, after making a hindsight comparison of earlier reserves, that reserve strengthening has occurred (Salzmann Report at 6; Salzmann Rebuttal re Bass at 3) when, in fact, the actuary may have taken no reserve strengthening action to achieve the observed result. Thus, three of the four experts opined that the mechanical test of the Regulation does not accurately measure reserve strengthening.

The Third Circuit misread the expert reports

The basis for the Third Circuit's conclusion that reserve strengthening has different meanings in the P/C industry is reflected in footnote 5 of its opinion. (App. at A-9 to A-10.) The Third Circuit describes the report of petitioner's expert, W. James MacGinnitie, in a manner that demonstrates that the court did not understand his opinion. Footnote 5 states: "According to Mr. MacGinnitie, in order to determine whether reserve strengthening has occurred one must compare the adequacy of the current reserve for a line of business to the adequacy of a previous reserve for that same line of business."

This was ***not*** Mr. MacGinnitie's testimony. Mr. MacGinnitie emphasized at the beginning of his report that he agreed with the definition of reserve strengthening as set forth in the report of petitioner's other expert, Irene Bass.[10] (MacGinnitie Report at 4.) He opined that the determination of changes in reserve adequacy (*i.e.*, reserve strengthening or weakening) must be made in relation to another value for the same reserve at the same point in time. (MacGinnitie Report at 7.) He went on to analyze reserves retrospectively at different points in time to determine whether they were relatively stronger or weaker. However, Mr. MacGinnitie did not express the opinion that such a retrospective review of reserves at different points in time represents reserve strengthening. Instead, his retrospective reserve analysis was intended to explain why the mechanical test of the Regulation does not even purport to measure the "strength" of reserves.

In footnote 5, the Third Circuit failed to acknowledge that the expert reports of respondent's expert, Ruth Salzmann, are in

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[10]It is true, as the Third Circuit states, that Ms. Bass' report stated that the term "reserve strengthening" is not well-defined in P/C actuarial, accounting, or insurance regulatory ***literature***. However, the fact that reserve strengthening is not written about extensively does not mean that it has no accepted meaning. Ms. Bass also stated that reserve strengthening has specific characteristics upon which there is near universal agreement among P/C actuaries. (Bass Report at 14-19.) Ms. Bass concluded that the term "reserve strengthening" has established characteristics and a commonly understood meaning in the P/C industry. (Bass Report at 30-33.) Ms. Bass went further to explain why the mechanical test of the Regulation is inconsistent with any accepted meaning of reserve strengthening. (Bass Report at 37-46.)

general agreement with petitioner's experts on the meaning of reserve strengthening. Ms. Salzmann points out, as did the other experts, that reserve strengthening is an increase in the relative adequacy of reserves. (Salzmann Report at 5.) She further acknowledged that: "If one does not have to put a value on it, the term generally means an increased confidence in the adequacy of current reserve levels." (Salzmann Report at 6.) In other words, Ms. Salzmann agreed with the basic thrust of petitioner's expert reports. This is made clear in her rebuttal reports. She specifically agreed with both Mr. MacGinnitie's and Ms. Bass' opinions on the meaning of reserve strengthening (*i.e.*, that it involves a change in assumptions and/or methodologies). (Salzmann Rebuttal re MacGinnitie at 1.) She only disagreed with Ms. Bass that a required characteristic of reserve strengthening is that the change in reserve assumptions and/or methodologies must be material.[11] (Salzmann Rebuttal re Bass at 1.)

Equally important, Ms. Salzmann agreed in both of her rebuttal reports that the mechanical test in the Regulation does not properly measure reserve strengthening. In fact, the quotation from her book included as Appendix II to her report, in essence, states that to use the term "reserve strengthening" to refer to the unfavorable development of reserves, as the Regulation does, is a "misnomer." (Salzmann Report at Appendix II.) She specifically states that the meaning of reserve strengthening in the Regulation "is not correct" (Salzmann Report at 7), and results in an "imperfect

[11]Although Ms. Salzmann did not disagree as to the meaning of reserve strengthening, she did take exception to the Bass and MacGinnitie reports in minor respects.

measurement" of reserve strengthening. (Salzmann Rebuttal re Bass at 3.)[12]

Respondent's other expert, Raymond S. Nichols, agreed that petitioner's experts properly defined reserve strengthening (Report of Raymond S. Nichols ("Nichols Report") at 2; Rebuttal Report of Raymond S. Nichols ("Nichols Rebuttal") at 10, 17) but opined that they did not describe the only meaning of reserve strengthening. He went on to equate reserve strengthening with the unfavorable development of reserves as his preferred definition — exactly the definition that respondent's other expert, Ruth Salzmann, said is incorrect. (Salzmann Report at 7.) The flaw in Mr. Nichols' report is revealed in his attempt to distinguish "reserve strengthening" from an increase in "reserve adequacy." (Nichols Report at 28-29.) Each of the other experts starts from the agreed premise that the "strength" of reserves refers to their adequacy. Mr. Nichols starts from a different premise — that reserve strengthening refers to "the impact of changes in reserves from one accounting date to another." (Nichols Report at 28.) It is important to bear in mind that Mr. Nichols' report is directly in conflict with the report of Ms. Salzmann, respondent's other expert.[13]

[12]The facts in petitioner's case indicate that petitioner's 1986 reserves were less adequate than its total 1985 reserves. From Ms. Salzmann's rebuttal reports, it is clear that she would have concluded that petitioner had not engaged in reserve strengthening; petitioner's total 1986 reserves were ***weaker*** than its total 1985 reserves.

[13]Mr. Nichols interprets Ms. Salzmann's report as stating the same test for reserve strengthening as the report of Mr. MacGinnitie, and disagrees with it. (Nichols Report at 3 n.3.)

In summary, three of the expert witnesses in this case essentially agreed on the meaning of reserve strengthening, *i.e.*, an intentional act to improve the relative adequacy of reserves. These three experts also agreed with Ms. Bass' characteristics of reserve strengthening, *i.e.*, it results from an actuary's change in reserve assumptions and/or methodologies. Although the fourth expert agreed that this is a permissible definition of reserve strengthening (Nichols Report at 2), he preferred a second definition that the other three experts state is an incorrect use of the term.

Amicus submits that the meaning of reserve strengthening in the P/C industry is clear — that it properly refers to an action taken by an actuary to increase the relative adequacy of current reserves. An essential characteristic of reserve strengthening is a change in reserve assumptions and/or methodologies; without such a change, reserve strengthening cannot occur. The fact that one of respondent's experts offered another definition that he prefers does not mean that the term is ambiguous. It simply means, as Ruth Salzmann stated, that his preferred definition is "not correct" (Salzmann Report at 7) and a "misnomer." (Salzmann Report at Appendix II.)

IV. THE REGULATION IS UNREASONABLE BECAUSE IT TREATS ALL LOSS PAYMENTS AS INCREASES IN RESERVES

In determining the amount of a company's reserve strengthening, the approach of the Regulation is to compare the company's reserves at the end of 1985 for accident years 1985 and prior with the company's reserves at the end of 1986 for those same accident years, then add loss payments during 1986. The Third Circuit and respondent have argued that this approach of the Regulation is justified by the description of

reserve strengthening in the Conference Report on the 1986 Act, 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-367 (1986) ("Conference Report"), as including "all additions to reserves." It is important to understand, however, that for most taxpayers, including petitioner and The Home Group, year-end 1986 reserves for pre-1986 accident years were actually less than year-end 1985 reserves.[14] In other words, comparing the two years-end, there actually were ***no additions to reserves*** in 1986.

In such cases, the approach of the Regulation finds reserve strengthening only by treating all loss payments during the year as additions to reserves. While the Conference Report provides that claims paid may be taken into account, nothing in the Conference Report suggests that the proper way to take them

[14]For example, respondent determined under the mechanical test of the Regulation that in 1986 The Home Group engaged in reserve strengthening in the amount of over $180 million, with respect to accident years prior to 1986. However, the loss reserves of The Home Group for accident years prior to 1986 were $729 million ***less*** on December 31, 1986, than the loss reserves for those same accident years were on December 31, 1985.

into account is to treat them all as additions to reserves.[15] Certainly, what is treated as reserve strengthening under the Regulation results in many instances simply from the fact that the insurer is required to pay a loss in an amount which exceeded the insurer's prior estimate of that loss, rather than from any attempt to add to reserves to improve the adequacy of year-end 1986 reserves. In short, it is not 1986 reserve additions that result in a denial of fresh start under the Regulation, but 1986 loss payments. A regulation which treats loss payments as reserve strengthening, in the face of an actual reduction in reserves, cannot be said to "implement the congressional mandate in some reasonable manner." *Cf. National Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 476-77 (1979) (quoting *United States v. Cartwright*, 411 U.S. 546, 550 (1973) (in turn quoting *United States v. Correll*, 389 U.S. 299, 307 (1967)). The Regulation is invalid.

[15]Properly read, the Conference Report means that all ***reserve strengthening*** additions to reserves are denied fresh start whether or not the reserve strengthening additions to reserves were reasonable or mandated by actuarial necessity. This interpretation is supported by the immediately preceding sentence in the Conference Report which refers ***only*** to "reserve strengthening additions" that are excluded from fresh start. Further evidence that the Conference Report refers only to reserve strengthening additions to reserves can be found in the remaining part of the sentence, which describes the "additions" as those "attributable to an increase in an estimate of a reserve." These words connote an action that is taken by the taxpayer — a reserve strengthening action of adding to an estimate of a current reserve.

CONCLUSION

For the foregoing reasons, this Court should reverse the Third Circuit's ruling.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

ATLANTIC MUTUAL INSURANCE CO.
AND INCLUDIBLE SUBSIDIARIES,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF *AMICI CURIAE* OF AMERICAN INSURANCE ASSOCIATION, ALLIANCE OF AMERICAN INSURERS, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES, AND REINSURANCE ASSOCIATION OF AMERICA IN SUPPORT OF PETITIONER

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This brief in support of petitioner is submitted with the written consent of counsel for petitioner and the Solicitor General filed with the Clerk of the Court.[1]

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[1] This brief was not authored in whole or in part by counsel for a party to this proceeding, and no person or entity, other than the *amici curiae*, their members, or their counsel, made a monetary

INTEREST OF THE *AMICI CURIAE*

The American Insurance Association, the Alliance of American Insurers, the National Association of Independent Insurers, the National Association of Mutual Insurance Companies, and the Reinsurance Association of America are the five leading associations of property and casualty insurers and reinsurers in the United States. Their members, comprised of over 2,000 insurance and reinsurance companies, write nearly 85 percent of the property and casualty insurance underwritten in the U.S. (including over $223 billion in direct premiums written in 1996), and substantially all of the property and casualty reinsurance assumed by U.S. companies on U.S. risks, and range in size from small companies that operate in a single state to the largest insurers with global operations. These companies are subject to the loss reserve discounting provisions of the Tax Reform Act of 1986, which include transition rules known as the "fresh start."

All five associations regularly file *amicus curiae* briefs in cases that have a significant impact on their member companies. In this case, the *amici* and their members believe that the United States Court of Appeals for the Third Circuit erred in upholding a regulation by which the Internal Revenue Service implemented a statutory limitation, referred to as "reserve strengthening," on the fresh start transition rules. If this decision is upheld, the insurance industry represented by these associations will suffer a severe financial burden, imposed in a capricious and inequitable manner on individual companies within that industry, that could not have been intended by Congress.

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contribution to the preparation or submission of this brief. The petitioner is a member of *amici* Alliance of American Insurers and National Association of Mutual Insurance Companies, but has not made a monetary contribution to the preparation or submission of this brief beyond that of other members of those *amici*.

SUMMARY OF ARGUMENT

In order to prevent abuse of the fresh start rules applicable to insurers and reinsurers transitioning to the loss reserve discounting provisions of the Tax Reform Act of 1986. Congress provided that certain types of "artificial" additions made in 1986 to loss reserves were to be denied the otherwise-available fresh start. Congress did not deny the fresh start to all reserve additions made in 1986, but only to those that resulted from "reserve strengthening." In Treasury Regulation § 1.846-3(c), under the guise of interpreting the statute, the IRS has taken a blunderbuss regulatory approach—transgressing the plain meaning and intent of the statute—to implement this narrow, tax-avoidance safeguard.

Atlantic Mutual contends that, by using the statutory term "reserve strengthening," Congress intended to deny the fresh start *only* to reserve increases resulting from a company's change in the assumptions or methodologies used to calculate loss reserves. The *amici* agree that the IRS's regulation is invalid because it conflicts with Congress' intent as evidenced by the plain and unambiguous language of the statute. The *amici* also contend that the IRS's regulation is invalid because it imposes an avowed "two wrongs make a right" approach, which conflicts with Congress's intent as evidenced by the legislative history of the statute. By perversely disallowing the fresh start with respect to virtually all nonartificial, or natural, reserve increases, and allowing it with respect to certain artificial reserve increases, this approach grossly and inequitably distorts the fresh start and arbitrarily impacts taxpayers in this industry in a manner that could not have been intended by Congress.

The legislative history confirms that Congress's purpose was to deny the fresh start to reserve additions attributable to changes in reserve assumptions and methodologies. Congress considered such reserve additions artificial and thus abusive. The IRS regulation, however, is sweeping and

indiscriminate in its scope, and denies the fresh start not only to artificial reserve additions attributable to changes in reserve assumptions and methodologies, but also to non-artificial reserve increases that occurred naturally under preexisting and unchanged reserve assumptions and methodologies. Indeed, the regulation is so overbroad and irrational that it denies the fresh start in some instances where there was no reserve increase whatsoever, and allows the fresh start in others where a reserve increase was admittedly artificial. The regulation is in conflict with the legislative history, which reflects a far more limited intent, and disregards the fact that Congress had no intent to deny the fresh start to nonartificial reserve increases not attributable to changes in assumptions and methodologies. Because the regulation is fundamentally at odds with the congressional mandate, this Court should hold the regulation invalid.

Under the "plain language" principle advanced by Atlantic Mutual and supported by the *amici,* Atlantic Mutual is entitled to prevail, because the government admits that Atlantic Mutual did not change its reserve assumptions or methodologies. Under the "legislative history" analysis in this *amici* brief, Atlantic Mutual also is entitled to prevail, because the government admits that Atlantic Mutual did not artificially increase any reserves. Atlantic Mutual, and the many companies represented by the *amici* with a stake in this issue, would have $1 billion of their fresh start adjustments taken away under the regulation's irrational mechanical rule for determining reserve strengthening.

ARGUMENT

I. THE *AMICI* AGREE WITH ATLANTIC MUTUAL THAT THE IRS REGULATION CONFLICTS WITH THE PLAIN LANGUAGE OF THE RESERVE STRENGTHENING SAFEGUARD IN THE STATUTE, AND ALSO CONTEND THAT THE REGULATION IS INVALID BECAUSE IT FAILS TO IMPLEMENT THE CONGRESSIONAL MANDATE IN A REASONABLE MANNER

This case involves the application of settled principles of statutory interpretation. Atlantic Mutual demonstrates that the language of the statute is clear from Congress's use of the term "reserve strengthening" and, thus, that it is entitled to prevail without further analysis of legislative history. We concur with Atlantic Mutual and do not further address the argument based on the plain language of the reserve strengthening provision.

The government contends (Res. Br. 15) that its position "draws substantial support from the legislative history of the statute." This brief demonstrates the opposite—that if resort is had to the legislative history, the IRS's interpretation of the statute is based on a impermissible contruction of the reserve strengthening provision, which has arbitrary impacts on affected insurers, and is invalid for this reason as well. In this regard, this Court has repeatedly made clear that, in order for an agency regulation to be accorded deference, it is not sufficient for the government to maintain that the words of the statute can conceivably bear the meaning the agency would ascribe to them. It is necessary in addition that the regulation "implement the congressional mandate in some reasonable manner." *Commissioner v. Engle,* 464 U.S. 206, 224 (1984) (quoting *United States v. Correll,* 389 U.S. 299, 307 (1967) (internal quotation marks omitted)); *National Muffler Dealers Ass'n v. United States,* 440 U.S. 472, 476-77 (1979) (quoting *United States v. Cartwright,* 411 U.S. 546, 550 (1973), in turn quoting *United States*

v. Correll, 389 U.S. 299, 307 (1967) (internal quotation marks omitted)).

The regulation at issue here not only fails to implement Congress's intent in a reasonable manner; it actually conflicts with the congressional mandate. The legislative history shows that Congress's purpose was to deny the fresh start to artificial reserve additions attributable to changes in the assumptions and methodologies used to establish reserves. The legislative history belies any intent to deny the fresh start to nonartificial reserve increases that occurred naturally under existing and unchanged reserve assumptions and methodologies. The gross over-inclusiveness of the IRS's regulation obliterates the distinction between artificial and nonartificial reserve increases that was at the heart of the limitation placed on the fresh start, producing absurd and arbitrary results that Congress could not have intended. For these reasons, discussed in detail below, the regulation should be held invalid.

II. THE TREASURY REGULATION AT ISSUE FAILS TO HARMONIZE WITH THE ARTICULATED PURPOSE OF THE STATUTE

In section 1023(c) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2399 (1986) (the "1986 Act"), Congress required that, beginning with the year 1987, property and casualty insurers and reinsurers [2] apply a present value methodology to discount their unpaid loss reserves. For purposes of 1987 tax computations, section 1023(e)(2) of the 1986 Act permits insurers to use discounted year-end 1986 reserves. General change-in-method-of-accounting principles ordinarily would require the inclusion in income of the difference between the undiscounted and discounted year-end 1986 reserves. To mitigate the transitional impacts of discounting, how-

[2] In this brief, unless the context indicates otherwise, the term "insurers" is used to refer to both insurers and reinsurers.

ever, Congress provided a fresh start that excludes this difference from taxable income.[3] 1986 Act, § 1023(e)(3)(A), 100 Stat. at 2404.

Congress also enacted a reserve strengthening safeguard in section 1023(e)(3)(B) of the 1986 Act out of concern that insurers could increase their fresh start adjustment by artificially inflating reserves in 1986.[4] As explained in the legislative history, this anti-abuse "provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision." H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-367 (1986) (hereinafter the "Conference Report").[5] To achieve this intended result, Congress specified in the statute that the "[fresh start provision] shall not apply to any reserve strengthening" occurring during the year 1986.

In Treasury Regulation § 1.846-3(c), an interpretative regulation issued to implement section 1023, the IRS prescribed a so-called "mechanical test" that broadly and arbitrarily denies the fresh start.[6] T.D. 8433, 1992-2 C.B. 146. The regulation denies the fresh start not only to artificial reserve additions attributable to changed reserve assumptions and methodologies, as Congress clearly intended, but also to virtually all nonartificial reserve increases that occurred naturally under existing reserve as-

[3] Just two years earlier, Congress had provided a "fresh start" with respect to significant changes in the way in which insurance companies calculate life insurance reserves for federal income tax purposes. Deficit Reduction Act of 1984, § 216, Pub. L. No. 98-369, 98 Stat. 494, 758 (1984) ("DEFRA").

[4] Congress similarly had included a "reserve strengthening" safeguard on the fresh start it had provided for insurers in DEFRA two years earlier. DEFRA, § 216, 98 Stat. at 758.

[5] For the convenience of the Court, we have reproduced the relevant portion of the Conference Report in the Appendix.

[6] The regulation contains limited exceptions, addressed to narrow circumstances, that are not relevant here.

sumptions and methodologies. The regulation is so overbroad that it also operates to deny the fresh start even in some cases where reserves were not increased at all. On the other hand, the regulation perversely allows the fresh start in other cases despite the existence of an artificial reserve increase.

Property and casualty insurers, in the ordinary course of their business, must establish and periodically adjust loss reserves in order to fulfill their obligations to policyholders.[7] Here, the government admits (Pet. 4-5) that Atlantic Mutual's reserves were both reasonable in amount and the natural result of the consistent application of Atlantic Mutual's preexisting reserve assumptions and methodologies. Indeed, the government stipulated (Pet. 4-5) that Atlantic Mutual took no action in 1986 with respect to its reserves that was tax motivated. Yet, the government seeks to enforce the IRS regulation, which, in this instance, mechanically denies a significant portion of the fresh start to Atlantic Mutual.

A. The Regulation Is Fundamentally at Odds with Congress's Purpose of Denying the Fresh Start to Artificial Reserve Additions

The statutory language at issue had its origin in a Senate bill. H.R. 3838, 99th Cong., 2d Sess., § 1022(e) (as reported by the Senate Finance Committee, May 29, 1986) (hereinafter the "Senate bill"). Insofar as relevant here, the Senate bill provided that the "[fresh start provision] shall not apply to any reserve strengthening."

The parties are in agreement that the Senate bill used the term "reserve strengthening" to refer only to reserve additions resulting from changes in reserve assumptions or methodologies. The Senate bill thus allowed the fresh start to insurers that continued to follow their existing reserve assumptions and methodologies. The accompanying Senate report is fully consistent with the text of the Senate bill. The report expresses the Senate's intent to deny the fresh start to reserve increases "attributable to changes in reserves on account of changes in the basis for computing reserves (i.e., reserve strengthening . . .)." S. Rep. No. 313, 99th Cong., 2d Sess. 510 (1986) (hereinafter the "Senate Report").

The term "changes in the basis for computing reserves," as used in the Senate Report, has a well established meaning in the insurance industry. The term encompasses only reserve additions that result from a change in the assumptions or methodologies used in calculating reserves.[8] In contrast, the term excludes reserve additions that are not attributable to a change in assumptions or methodologies, but that occur naturally as the insurer continues to follow and apply its existing reserve assumptions and methodologies.[9]

The government admits (Res. Br. at 4) that the Senate bill "limited [the term] reserve strengthening to changes

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[7] Similarly, reinsurers must establish and periodically adjust loss reserves in order to fulfill their obligations to insurers.

[8] A "change in basis" is a specialized type of "change in method of accounting," which is a term the IRS has defined in regulations issued under Internal Revenue Code section 446. In discussing the life insurance provisions of the Code, upon which the Senate bill was based, the IRS has acknowledged that "the term 'basis' is used interchangeably with 'method' when describing the effects of a change in basis of computing reserves." Rev. Rul. 94-74, 1994-2 C.B. 157, 159. *See American Gen. Life & Accident Ins. Co. v. United States*, 90-1 U.S.T.C. (CCH) ¶ 50,010, at 83,042 (M.D. Tenn. 1989) (a "change in basis" is a "type of 'change in method of accounting' ").

[9] For example, changes in accounting method do not include the "correction of mathematical or posting errors." Treas. Reg. § 1.446-1(e)(2)(ii)(b). The IRS has ruled that "consistent with section 446, the correction of reserves for a mathematical or posting error would not be treated as a change in basis . . . ." Rev. Rul. 94-74, 1994-2 C.B. at 160. Likewise, changes in accounting method do not include "a change in treatment resulting from a change in underlying facts." Treas. Reg. § 1.446-1(e)(2)(ii)(b). A reserve addition attributable to changed facts similarly is not a change in basis of computing reserves.

in reserve practices." The government thus agrees (Res. Br. at 15) that the Senate bill denied the fresh start only to reserve increases attributable to "changes in reserve methodologies."

In denying the fresh start in the case of changes in reserve assumptions and methodologies (*i.e.*, "reserve strengthening"), the Senate bill reflected an obvious intent. As the court below explained (Pet. App. A5):

> Congress anticipated . . . the potential for abuse created by the fresh start provision—that insurers could manipulate the fresh start provision by inflating their reserves. To prevent abuse, Congress enacted section 1023(e)(3)(B) to exclude any increases in loss reserves due to "reserve strengthening."

As the subsequent Conference Report expressly stated, "[the statutory] provision is intended to prevent taxpayers from *artificially* increasing the amount of income that is forgiven under the fresh start provision." Conference Report at II-367 (Appendix) (emphasis added).

Under existing reserve assumptions and methodologies, reserve adjustments (both increases and decreases) occur naturally, for example as a reserve methodology responds to changes in facts or law. By contrast, a "change in basis" occurs only when there is a departure from existing reserve assumptions or methodologies, and it is within an insurer's discretion or control whether to make such a departure. The Senate bill reflected the concern that an insurer could abuse the fresh start by changing its basis for computing reserves in 1986. Accordingly, the Senate bill treated any "change in basis" occurring in 1986 as an artificial manipulation intended to take advantage of the fresh start.

The conference committee included in the conference bill the same term used in the Senate bill—"reserve strengthening"—which the parties agree applies only to "changes in basis." In its report, the conference committee emphasized that its intent was to deny the fresh start

to artificial reserve increases. In accordance with this intent, the Conference Report provided that, for purposes of denying the fresh start, the term reserve strengthening should be "considered to include" three categories of artificial reserve increases. As described below, analysis of the Conference Report confirms that the committee's purpose was to deny the fresh start to reserve increases attributable to changes in reserve assumptions or methodologies.

Preliminarily, it is important to note that the conference committee did not provide for all reserve increases to be denied the fresh start (as the IRS's regulation seeks to do). The conference bill denied the fresh start only to "reserve strengthening," thus employing the same terminology as the Senate bill, and the Conference Report confirmed the intent to cover only "reserve strengthening additions," not all reserve additions. Conference Report at II-367 (Appendix). Importantly, the Conference Report carefully prescribed the limited goal of "prevent[ing] taxpayers from *artificially* increasing" reserves, and thereby increasing the amount of income forgiven under the fresh start. *Id.* (Appendix) (emphasis added).[10] Consistently, the Conference Report states that the fresh start should be denied, not to all reserve increases, but only to specific categories of reserve increases. This legislative history is wholly inconsistent with the IRS's regulation, which extends indiscriminately to essentially all nonartificial reserve increases, and then fails to capture all artificial increases.

The first two categories of reserve increases mentioned in the Conference Report relate to changes in reserve assumptions and methodologies. In the first category, the

[10] This intent to deny the fresh start to artificial reserve additions was reemphasized in the "Bluebook" prepared for the Tax Reform Act of 1986. Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1986* 618 (Jt. Comm. Print 1987).

Conference Report reaffirms the Senate's decision that traditional reserve strengthening, *i.e.*, changes in basis, should be denied the fresh start. The Conference Report provides that "reserve strengthening" includes "all additions to reserves attributable to an increase in an estimate of a reserve established for a prior [pre-1986] accident year." Conference Report at II-367 (Appendix). This category applies to reserve estimates that insurers held as of year-end 1985. As described above, insurers had determined those reserve estimates by applying reserve methodologies based on particular assumptions. The conference committee proceeded on the assumption that if, in reporting its reserve estimates for 1986, an insurer simply continued to utilize existing reserve assumptions and methodologies, there would be no increase in a reserve estimate and no change in basis. On this assumption, mere increases in 1986 reserves over 1985 reserves that occurred naturally under an existing methodology, and not as the result of a change in reserve assumptions or methodologies, would not be changes in basis and would not be denied the fresh start.[11]

In the second category, the Conference Report states that "reserve strengthening" also should be considered to include "additions to reserves resulting from a change in the assumptions . . . used in estimating losses for the 1986 accident year." *Id.* This category applies to reserve estimates first established during 1986. Because these reserve estimates did not exist at year-end 1985, reserve strengthening cannot be determined under the category one method of comparing the year-end 1986 reserve estimates to year-end 1985 reserve estimates. Instead, it is necessary

[11] Any reserve held at year-end 1985 was eliminated during 1986 if the related claim was paid in 1986. To account for this, the Conference Report states that, when comparing year-end 1985 reserve estimates and year-end 1986 reserve estimates, the year-end 1985 reserve estimates must be reduced to "tak[e] into account claims paid [during 1986] . . . ." Conference Report at II-367 (Appendix).

to determine whether the insurer, in establishing the reserve estimates in 1986, used the same reserve assumptions and methodologies that it would have used had it established the reserve estimates in 1985.[12] The conference committee intended that insurers be permitted to establish new reserve estimates during 1986 using their existing reserve assumptions and methodologies, and intended to deny the fresh start only if there was a change in the prior assumptions and methodologies.

As the third category, the Conference Report denies the fresh start to "all unspecified or unallocated additions to loss reserves." Conference Report at II-367 (Appendix). The scope of this category is unclear, because property and casualty insurers are required to identify additions to their reserves and to allocate reserves to particular lines of business and accident years. This category seems to encompass only reserve additions attributable to unspecified reasons outside the existing reserve methodology and unrelated to facts relevant under the existing reserve methodology. Whatever this category's limited scope, it clearly does not include reserve increases that occurred naturally under preexisting reserve assumptions and methodologies, and provides no support for the IRS's regulation which denies the fresh start to all nonartificial reserve additions.

If the legislative history is to be read harmoniously, the first category described above must be interpreted to cover only changes in the assumptions or methodologies used to determine existing reserves for pre-1986 accident years. In the language describing the second category of reserve increases denied the fresh start, which immediately follows the language describing the first category, the Con-

[12] The IRS's regulation requires that insurers compute a "hypothetical" year-end 1985 reserve "computed using the same assumptions . . . that were used to determine the 1985 accident year reserve, if any, for the line of business for which the hypothetical reserve is being computed." Treas. Reg. § 1.846-3(c)(2)(ii).

ference Report refers to "additions to reserves *resulting from a change in the assumptions . . . used in estimating losses* for the 1986 accident year." Conference Report at II-367 (Appendix) (emphasis added). This language reflects the conference committee's view that assumptions and methodologies are used to determine reserve estimates.[13] Thus, by describing the first category of reserve increases to be denied the fresh start as those "attributable to an increase in an estimate of a reserve," the conference committee was referring to "an increase in an estimate . . . resulting from a change in the assumptions" used to establish that estimate.

The government contends that by using the language "all additions to reserves attributable to an increase in an estimate of a reserve," the conference committee intended the first category to include "all additions to reserves." Of course if this were true, the conference committee would not have found it necessary to add the limiting language "attributable to an increase in an estimate of a reserve" that immediately follows "all additions to reserves." Under the government's approach, that limiting language is meaningless surplusage. Likewise, under the government's approach, there was no need for the conference committee to separately deny the fresh start to the third category of reserve increases—"all unspecified or unallocated additions to loss reserves." If the government were correct that the first category encompasses all reserve increases, the conference committee had no need to provide for this third category, and the Conference Report language doing so also is meaningless surplusage.

[13] The IRS shares this view. As described in note 12, *supra*, Treasury Regulation § 1.846-3(c)(2) requires that insurers compute a "hypothetical" 1985 reserve estimate with respect to the 1986 accident year "using the same assumptions" used to compute 1985 reserve estimates. It would be impossible for an insurer to compute such a "hypothetical" reserve estimate unless the insurer computed its loss reserves by consistently applying specific reserve assumptions and methodologies.

Perhaps most telling is that in describing what reserve increases were to be denied the fresh start, the conference committee was careful to state that its intent was to reach *artificial* increases. If the government were correct that the conference committee intended that its anti-abuse provision deny the fresh start to *all* reserve increases—without regard to their artificiality—then the Conference Report's statement that the provision was intended to reach artificial reserve increases is inconsistent and contradictory. Indeed, when the IRS announced its regulation in final form, and quoted the Conference Report, it omitted the conference committee's statement that it intended to deny the fresh start to artificial reserve increases, presumably because it was unable to reconcile its regulation with the conference committee's expressed intent. T.D. 8433, 1992-2 C.B. 146. In the end, the government's contentions with respect to the Conference Report are unpersuasive.[14]

The IRS's regulation expands the scope of fresh start denial beyond artificial reserve additions attributable to changes in assumptions and methodologies to include non-artificial increases occurring under preexisting assumptions and methodologies. Such natural reserve increases are required in order for an insurer to meet its obligations to pay the claims of its policyholders. Such increases are not abusive, and Congress did not intend its anti-abuse rule to deny these increases the fresh start. Nor is there any reason to do so. Because the IRS's regulation is at

[14] In his memorandum opinion below, Tax Court Judge Foley implied (Pet. App. A41) that in *Western Nat'l Mut. Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd*, 65 F.3d 90 (8th Cir. 1995), the Tax Court found the IRS's regulation to be "consistent with" the Conference Report. Judge Foley misinterpreted *Western National*. While the Tax Court did state that some support "can be found in the legislative history" for the regulation, the Tax Court expressly held (102 T.C. at 355) that the legislative history "provides no persuasive rationale" for the government's position and declared the regulation contrary to Congress's intent and therefore invalid.

odds with Congress's clearly expressed purpose to cover artificial reserve additions, this Court should hold the regulation invalid.

B. The Regulation Implements the Statute in an Arbitrary and Unreasonable Manner

The IRS regulation conflicts with Congress's intent not only because it seeks to deny the fresh start to non-artificial reserve increases, but also because it imposes a mechanical test that operates in an arbitrary and capricious manner that Congress could not have intended. As explained below, the regulation perversely denies the fresh start in situations not intended by Congress and allows the fresh start in other cases not intended by Congress.

The mechanical test operates erroneously and absurdly by creating "phantom" reserve strengthening when none actually exists. For example, assume that an insurer transferred a risk to a reinsurer, that the reinsurer established a reasonable $50,000 reserve for that risk, and that the insurer was permitted to eliminate its own $50,000 reserve for the risk. If the reinsurer encountered financial difficulties during 1986—as occurred in a number of instances—the insurer itself was required to reinstate the $50,000 reserve that it previously had been permitted to eliminate because of the reinsurance. In this situation, actually faced by member companies of the *amici*, the IRS's mechanical test creates $50,000 of "phantom" reserve strengthening for the insurer, despite the fact that no reserve strengthening actually occurred.

Another situation, frequently faced by member companies of the *amici* during 1986, involves claims that were closed in years before 1986, but which had to be reopened in 1986 by reason of the disclosure to the insurers of previously unknown facts. Upon the reopening of these claims in 1986, the insurers were required to set up loss reserves. In these situations, the IRS's mechanical test also creates "phantom" reserve strengthening.

There are many other instances, commonly faced by member companies of the *amici*, where application of the regulation's mechanical rule finds reserve strengthening, even though there is no possibility of any reserve increase. To illustrate, assume that an insurer established four loss reserves of $500 each, for a total of $2,000. In the following year, assume that the insurer paid two of the four claims for which the reserves were held for $750 each, for a total of $1,500, and continued to maintain the two $500 reserves for the unpaid claims. On these facts, the regulation's mechanical test creates $500 of "phantom" reserve strengthening (after payments of $1,500 were made with respect to year one reserves of $2,000, year two reserves were not $500, but rather $1,000). Yet, no actual reserve strengthening occurred. The insurer did not increase (but rather decreased) its reserves, but the IRS's mechanical test nevertheless creates "phantom" reserve strengthening based solely on the amounts of the claim payments that the insurer made to policyholders.

The IRS's regulation also would erroneously disallow fresh start in cases where actual 1986 reserve increases were made attributable to changes in law (statutory, regulatory or judicial) or the correction of an error in determining reserves for a prior year. These are not merely hypothetical situations; many member companies of the *amici* made such reserve additions during 1986.

The IRS acknowledges that its mechanical test "does not take into account" the situations described above, and thus will result in the "erroneous inclusion" of "certain amounts in the computation of reserve strengthening . . . ." Prop. Treas. Reg. § 1.846-3, 56 Fed. Reg. 20,161, 20,162 (1991) (Preamble). The IRS freely admits—in what is surely the epitome of understatement—that under the regulation there is "the absence of total accuracy." This inaccuracy, while unjust, is not by itself dispositive, because there is no requirement that regulations achieve perfect results. The key point is that by irrationally creat-

ing "phantom" strengthening, the regulation operates in a manner that Congress could not have intended.

The government attempts to justify its mechanical test by asserting that the "inaccuracies are likely to offset each other in the aggregate." 56 Fed. Reg. at 20,162. Rather than take this "two wrongs make a right" approach, a proper regulation would implement the rule that Congress actually adopted. Moreover, there is no support for the government's assertion that the inaccuracies caused by the test are likely to even out.

For an insurer that ultimately paid losses on claims in amounts that were greater than its reserves for those claims (as in the immediately preceding example), the regulation unfairly creates substantial amounts of "phantom" reserve strengthening. On the other hand, consider an insurer that ultimately paid losses on claims in amounts that were less than its reserves for those claims. For example, assume that an insurer established four reserves in year one of $500 each (for a total of $2,000), and then paid $250 apiece with respect to two of the four claims in year two ($500 total), while maintaining the two $500 reserves for the unpaid claims. The mechanical test detects "phantom" reserve weakening of $500 (after making payments of $500 with respect to year one reserves of $2,000, year two reserves were not $1,500, but rather $1,000). Thus, on facts where neither insurer has strengthened reserves, but simply paid different amounts of losses, the regulation unfairly denies the fresh start to the insurer whose paid losses were greater than its reserves, but not to the insurer whose paid losses were less than its reserves. Moreover, suppose the latter insurer artificially changed its reserve methodologies to increase its remaining year two reserves from $500 each to $750 each (for a total of $1,500). The IRS's mechanical test would not detect this actual reserve strengthening and, contrary to

Congress' intent, would not deny any of the fresh start.[15] Simply put, the IRS's mechanical test is absurd and unjustified.

Addressing these types of distortions resulting from the application of the IRS's regulation, the Third Circuit stated (Pet. App. A23-A24) that if the test is flawed, taxpayer's recourse is to Congress, and not the courts, and that the courts must focus, not on the "Act's policy," but rather on what Congress intended in enacting it. The *amici* agree, but disagree that these points weigh in favor of the government. The test that is flawed is the IRS's blunderbuss regulation, not the focused reserve strengthening safeguard provided for by Congress in the 1986 Act. Moreover, the *amici* do not object to the "Act's policy," but rather to the conclusion that the inequitable and grossly distorted effects in the insurance industry resulting from the IRS's regulation could have been intended by Congress.

As a last refuge, the government contends that the regulation can be defended on the ground that it "avoids significant compliance and administrative burdens." Prop. Treas. Reg. § 1.846-3, 56 Fed. Reg. at 20,162 (1991) (Preamble). This is little more than *ipse dixit* which the IRS has never even attempted to quantify or substantiate. In any event, this Court should not allow the IRS to impose a substantial tax burden that Congress did not intend solely on the ground of administrative convenience.

Moreover, because the statute requires a determination of reserve strengthening for only one year (1986), whatever burden exists cannot be considered significant. In this regard, it is important to note that, with respect to reserves for the 1986 accident year (category two), the regulation requires the determination of a hypothetical 1985 reserve using the same reserve assumptions actually used to determine 1985 reserves. Treas. Reg. § 1.846-3(c)(2). Once

[15] The government's argument that the mechanical test must be overly broad in order to reach all artificial abuses is thus incorrect.

those 1985 reserve assumptions are determined, it would impose little additional burden to determine whether those reserve assumptions were used without change to determine 1986 reserves for pre-1986 accident years (category one). Thus, the government's administrative burden argument is spurious.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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APPENDIX

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. at II-367 (1986).

* * * * *

Fresh start adjustment

The conference agreement follows the Senate amendment with respect to providing a fresh start adjustment—i.e., a forgiveness of income—for the reduction in reserves resulting from discounting the opening reserves in the first post-effective date taxable year of the provision. The conference agreement modifies the Senate amendment with respect to the treatment of reserve strengthening under the fresh start income forgiveness provision. Under the conference agreement, reserve strengthening in taxable years beginning after December 31, 1985, is not treated as a reserve amount for purposes of determining the amount of the fresh start. Instead, such reserve strengthening additions to loss reserves in taxable years beginning in 1986 are treated as changes to reserves in taxable years beginning in 1987, and are subject to discounting. Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves. This provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision.

The amount of the fresh start forgiveness of income is included in earnings and profits for the taxpayer's first taxable year beginning after December 31, 1986.

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